

**PROFESSIONAL PROGRAMME
STUDY MATERIAL**

**STRATEGIC
MANAGEMENT
ALLIANCES AND
INTERNATIONAL
TRADE**

MODULE III - PAPER 5



**THE INSTITUTE OF
Company Secretaries of India**

IN PURSUIT OF PROFESSIONAL EXCELLENCE
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PROFESSIONAL PROGRAMME

**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

Strategy is a broad concept that covers a multitude of different issues, concepts and methods. Strategy requires a significant amount of work to understand and even the experts often find themselves searching for new ways to research and think about the topic. For managers and leaders, strategy is at the centre of the effort to create value for customers to respond to competitive challenges and to build strong organizations. All this leads to make optimum utilization of organization's material and human resources in order to achieve better financial performance, improved qualitative decisions, employee motivation, minimum resistance to change, etc. by using various theories, models and management techniques. An organization always operates in the environment of risk and uncertainty which is the result of operation of multiple forces i.e. economic, technological, legal, political, social and global. Strategic management helps the organization to develop set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of an organization in a given frame work.

The establishment of World Trade Organisation ushered in a new era of global economic co-operation reflecting the widespread desire to operate in a fairer and more open multilateral trading system. The overriding purpose of World Trade Organisation is to help trade flow as freely as possible as long as there is no undesirable side effect. It serves as a forum for trade negotiations and for dispute settlement between the parties. The WTO agreement recognizes the need to secure for developing countries, particularly the least developed, a growth in the share of international trade commensurate with the needs of their economic development. In the wake of WTO, the International trade has also become a vital component of development strategy, which can be used as an effective instrument of economic growth.

In the light of above discussion, this study material has been prepared to provide sufficient exposure in strategic management, international trade, particularly in the context of World Trade Organisation. Added emphasis has been laid on strategic alliances, foreign collaborations and joint ventures abroad, to enable the candidates to discharge efficient services and to tackle practical situations.

The entire paper has been discussed in sixteen study lessons, divided into three parts i.e., Part A - Strategic Management, Part B, Strategic Alliances and Part C International Trade. Every effort has been made to give a comprehensive coverage of all the topics relevant to the subject. In fact, this being a management oriented paper; students need to have good blend of theoretical knowledge and practice to attain the requisite proficiency and confidence. Various changes made up to August 2011 have been included in the study material. However, it may so happen that some developments might have taken place during the course of time. Therefore, in order to supplement the information/contents given in the study material, students are advised to

(iv)

refer to the Suggested Readings mentioned in the study material, Student Company Secretary, Business Dailies and corporate journals.

In the event of any doubt, students may write to the Directorate of Academics and Professional Development of the Institute for clarification.

Although due care has been taken in publishing this study material yet the possibility of errors, omissions and/or discrepancies cannot be ruled out. This publication is released with an understanding that the Institute shall not be responsible for any errors, omissions and/or discrepancies or any action taken in that behalf.

Should there be any discrepancy, error or omission noted in the study material, the Institute shall be obliged if the same is brought to its notice for issuance of the corrigendum in the Student Company Secretary bulletin.

(v)

PROFESSIONAL PROGRAMME
SYLLABUS
FOR
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

Level of Knowledge: Working Knowledge.

Objectives: To develop the basic understanding of the students about the concepts, techniques and processes relating to strategic management, alliances as well as International Trade and treaties including World Trade Organisation.

Detailed contents:

PART A : STRATEGIC MANAGEMENT (40 MARKS)

1. Nature and Scope of Strategic Management

Concept; role, functions and processes of strategic management in globally, competitive and knowledge-based environment.

2. Environmental Scanning and Internal Appraisal Analysis

(a) Identification of external variables - economic, technological, legal, political, socio-cultural and, global; industry appraisal analysis and forecasting; synthesis of external factors;

(b) Internal scanning of the firm;

(c) Tools and techniques of strategic management – SWOT analysis, situational analysis; Gap analysis, impact analysis, value chain analysis; business process re-engineering.

3. Planning and Formulation

Formulation of corporate vision, mission, goals and objectives; developing strategic alternatives, evaluations of alternatives, selection of best alternative; strategic planning vis-à-vis tactical planning; Strategic models for optimal decision-making.

4. Implementation and Control

Strategy implementation; developing programs, budgets and procedures; strategic control; managing strategic changes.

5. Review

Performance evaluation - criteria and challenges

6. Risk Management

Meaning, objectives and significance; types of risks; measuring the trade off between risk and return; control and management of business risks.

7. Management Information Systems

Concept, elements and structure; approaches of MIS development; pre-requisites of an effective MIS, Enterprise Resource Planning (ERP).

8. Internal Control Systems

Meaning, definition, objectives, classification, scope and limitation of internal control; steps and techniques of internal control systems.

PART B : STRATEGIC ALLIANCES (20 MARKS)

9. Nature and Scope

Meaning, types and stages; integrating alliances into corporate strategy; cross cultural alliances; implementation and management of strategic alliances.

10. Foreign Collaborations and Joint Ventures

Industrial Policy; Foreign Investment Policy; kinds and negotiation of collaboration and joint ventures, drafting of agreement, restrictive clauses; Indian joint ventures abroad – Indian experiences.

PART C : INTERNATIONAL TRADE (40 MARKS)

11. International Trade and Treaties

Concept and Theories of International Trade, Institutionalisation of international trade, establishment of World Trade Organisation; Economic Blocks and Trade Agreements such as ASEAN, EU, SAPTA, NAFTA etc.; India's Free Trade, Economic Cooperation and Partnership Agreements.

12. Anti-dumping, Subsidies and Countervailing Duties

WTO agreements on anti-dumping; safeguard measures; subsidies & countervailing duties; Regulatory Framework and procedure in India.

13. Settlement of Disputes under WTO

Rules, regulations and procedures relating to settlement of disputes under WTO.

LIST OF RECOMMENDED BOOKS
STRATEGIC MANAGEMENT, ALLIANCES AND INTERNATIONAL TRADE

Readings:

1. L.M. Prasad : Strategic Management; Sultan Chand & Sons, 23, Daryaganj, New Delhi – 110 002.
2. P.K. Ghosh : Strategic Planning and Management; Sultan Chand & Sons, 23, Daryaganj, New Delhi-110 002.
3. C N Sontakki : Strategic Management; Kalyani Publishers, 23, Daryaganj, New Delhi – 110 002
4. C.B. Gupta : Corporate Planning and Policy; Sultan Chand & Sons, 23, Daryaganj, New Delhi – 110 002.
5. Gordon B. Davis & Margrethe H. Olson : Management Information Systems, Conceptual Foundations, Structure and Development, MacGraw Hill Education (India) Ltd., B-4, Sector 63, Gautam Budh Nagar, Noida-201301.
6. A.V. Vedpuriswar : Enterprise Risk Management, Vision Books Pvt. Ltd., Lajpat Nagar-III, New Delhi-24.
7. Kamal Gupta : Contemporary Auditing; MacGraw Hill Education (India) Ltd., B-4, Sector 63, Gautam Budh Nagar, Noida-201301.
8. Vipin Gupta, Kamala : Business Policy and Strategic Management, Concepts & Applications; Prentice Hall of India Pvt. Ltd., New Delhi – 110 001.
9. M.B Rao & Manjula Guru : WTO and International Trade; Vikas Publishing House Pvt. Ltd., A-22, Sector-4, Noida-201 301.
10. Sheela Rai : Anti-Dumping Measures under GATT/ WTO; Eastern Book Company, 34, Lalbagh, Lucknow- 226 001.
11. D.C. Singhanian : Foreign Collaboration and Investment in India; Universal Law Publishing Co. Pvt. Ltd., New Delhi.
12. M.G. Basvraja : World Trade Organisation; Serial Publication Khyberpas Market, Civil Market, Delhi – 54.
13. Dr. Raj Agarwal : Joint Venture—Law and Management; Bharti Publishing House, New Delhi.
14. Reference on WTO & GATS : ICSI Publication.

References:

1. Barney, Hesterly : Strategic Management and Competitive Advantage Concepts; Prentice Hall of India Pvt. Ltd., New Delhi – 110001.
2. Thomas L. Wheelan & J. David Hunger : Strategic Management and Business Policy—Addison-Wesley
3. Arthur Sharplin : Strategic Management International Students Editions, McGraw-Hill Education (I) Ltd.
4. Robert A. Pitts, David : Strategic Management—Building and Sustaining Competitive Advantage-Thomson South-Western (Indian Print)
5. Harrington Niehous : Risk Management & Insurance; McGraw-Hill Education (I) Ltd.
6. Manohar L Gulati : Strategic Planning and Management; Amexcel Publications Pvt. Ltd., Naraina Phase-I, New Delhi-28.
7. Munesh Kumar : Business Information Systems; Vikas Publishing House Pvt. Ltd., A-22, Sector-4, Noida – 201 301.
8. R.K. Gupta : Safeguards Countervailing and Anti-Dumping Measures, Academy of Business Study, Ansari Road, New Delhi – 110 002.
9. David Faulker : Strategic Alliances/International Business: A Strategic Management Approach; McGraw-Hill Education.

CONTENTS

<i>Study Lesson No.</i>	<i>Contents</i>
-------------------------	-----------------

**PART A
STRATEGIC MANAGEMENT**

I.	Nature and Scope of Strategic Management
II.	Environmental Scanning and Internal Appraisal Analysis
III.	Planning and Formulation
IV.	Implementation and Control
V.	Performance Evaluation
VI.	Risk Management
VII.	Management Information System
VIII.	Internal Control Systems

**PART B
STRATEGIC ALLIANCES**

IX.	Nature and Scope of Strategic Alliances
X.	Foreign Collaborations and Joint Ventures

**PART C
INTERNATIONAL TRADE**

XI.	International Trade and Treaties
XII.	World Trade Organisation (WTO)
XIII.	WTO – Ministerial Conferences
XIV.	Anti-dumping Duties
XV.	Subsidies and Countervailing Duties
XVI.	Settlement of Disputes under World Trade Organisation

PROFESSIONAL PROGRAMME
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

C O N T E N T S

**PART A
STRATEGIC MANAGEMENT**

**STUDY I
NATURE AND SCOPE OF STRATEGIC MANAGEMENT**

	<i>Page</i>
Learning Objectives	... 1
Concepts of Strategy	... 1
Levels of Strategy	... 3
Deliberations of Strategy	... 5
Strategic Management	... 7
Evolution of Strategic Management	... 9
Nature of Strategic Decisions and Strategic Thinking	... 11
Role of Strategic Management	... 12
Functions of Strategic Management	... 14
Benefits of Strategic Management	... 14
Limitations of Strategic Management	... 16
Strategic Management Process	... 17
Strategic Management in Global Business Scenario	... 21
Risks in Global Business	... 23
Reasons for Doing Business Globally	... 24
Issues in Global Business	... 25
Strategic Management and Technology	... 26
Strategic Management in Knowledge Based Environment	... 28
Elements of Knowledge Management	... 29
Importance of Knowledge Management	... 30
Implementation of Knowledge Management Programme	... 31
Innovation and Knowledge Strategy	... 33
Lesson Round-Up	... 34
SELF-TEST QUESTIONS	... 35

STUDY II
**ENVIRONMENTAL SCANNING AND INTERNAL
 APPRAISAL ANALYSIS**

Learning Objectives	...	36
Introduction	...	36
Informal and Formal Scanning	...	38
Environmental Analysis	...	39
Economic Environment	...	40
Technological Environment	...	43
Political – Legal Environment	...	45
Socio Cultural Environment	...	46
Global Environment	...	47
Forecasting	...	48
Forecasting Techniques	...	49
Limitations of Forecasting	...	52
Industry Analysis	...	53
Porter’s Five Forces Model of Industry Analysis	...	54
Strategic Group Mapping	...	58
Synthesis of External Factors	...	59
Internal Scanning of the Firm	...	60
Internal Financial Analysis	...	61
Internal Functional Analysis	...	65
Identification of Major Functional Areas	...	67
Tools and Techniques of Strategic Management	...	69
SWOT Analysis	...	69
Situational Analysis	...	73
PEST Analysis	...	74
Gap Analysis	...	76
Planning of Gap	...	77
Impact Analysis	...	80
Value Chain Analysis	...	81
Business Process Reengineering (BPR)	...	90
Lesson Round-Up	...	93
SELF-TEST QUESTIONS	...	94

STUDY III
PLANNING AND FORMULATION

Learning Objectives	...	96
Introduction	...	96
Vision	...	97
Mission	...	98
Vision and Mission Statements	...	101
Goals and Objectives	...	101
Features of Objectives	...	103
Objective Setting	...	104
Guidelines for Objective Setting	...	105
Developing Strategic Alternatives	...	105
Offensive Strategies	...	106
Focus Strategies	...	110
Integration Strategies	...	111
Diversification Strategies	...	112
Rationale for Diversification and Integration	...	116
Cost of Diversification	...	117
Defensive Strategies	...	118
Other Strategies	...	121
Evaluation of Strategic Alternatives	...	123
BCG Matrix or Growth-Share Matrix (GSM)	...	124
GE Matrix/McKinsey Matrix	...	127
Life Cycle Analysis	...	130
Selection of Best Alternative	...	134
Strategic Planning	...	137
Characteristic of Strategic Planning	...	137
Operational Planning	...	138
Strategic Planning and Operational Planning	...	139
Co-ordination of Strategic and Operational Planning	...	140
Tactical Planning	...	140
Strategic Planning and Tactical Planning	...	141
Strategic Decision Making	...	142
Lesson Round-Up	...	148
SELF-TEST QUESTIONS	...	149

STUDY IV
IMPLEMENTATION AND CONTROL

Learning Objectives	...	151
Concepts of Strategy Implementation	...	151
Strategy Formulation and Implementation	...	152
Strategy Implementation—Supporting Factors	...	153
Issues in Strategy Implementation	...	155
McKinsey 7-S Framework	...	157
Activating Strategy	...	160
Structural Implementation	...	162
Forms of Organization Structure	...	163
Procedural Implementation	...	168
Behavioural Implementation	...	169
Functional Implementation	...	178
Marketing Strategy	...	179
Finance Policies	...	180
Working Capital Management	...	181
Human Resource Management and Union Relations Policy	...	182
Production Strategy	...	185
Research and Development Strategy	...	185
Strategic Programming	...	189
Budgets	...	190
Procedures	...	194
Strategic Control	...	195
Control Process	...	198
Strategic Control Techniques	...	200
Strategic Change Management	...	202
Managing Strategic Changes	...	209
Lesson Round-Up	...	210
SELF-TEST QUESTIONS	...	212

STUDY V
PERFORMANCE EVALUATION

Learning Objectives	...	213
Introduction	...	213
Measures of Corporate performance	...	214
Balanced Score Card Approach	...	220

	<i>Page</i>
Evaluating Top Management	... 222
Job of Management	... 223
Measuring Divisional Performance	... 224
Choice of Performance Measure	... 227
Evaluating Functional Performance	... 228
Benchmarking to Evaluation Performance	... 231
Problems in Measuring Performance	... 232
Strategic Incentive Management	... 233
Strategic Audit	... 234
Lesson Round-Up	... 234
SELF-TEST QUESTIONS	... 235

STUDY VI

RISK MANAGEMENT

Learning Objectives	... 237
Introduction	... 237
Components of Cost of risk	... 241
Types of Risks	... 242
Elements of Risk in Business	... 246
Concept of Risk Management	... 248
Significance of Risk Management	... 250
Benefits of Risk Management	... 251
Scope and Applicability of Risk Management	... 252
Risk Management Process	... 253
Trade off Between Risk and Return	... 261
Measurement of Risk and Return	... 262
Management of Business Risks	... 264
Responsibilities of Risk Management	... 267
Strategies for Risk Mitigation	... 268
Maintaining the Risk Strategy	... 270
Lesson Round-Up	... 272
SELF-TEST QUESTIONS	... 273

STUDY VII

MANAGEMENT INFORMATION SYSTEMS

Learning Objectives	... 274
MIS – Concept	... 274

	<i>Page</i>
Evolution of MIS	... 275
Elements of MIS	... 280
Management Levels and their Information Needs	... 281
Definition of MIS	... 286
Characteristics of MIS	... 287
Misconception or Myths about MIS	... 290
Structure of MIS	... 290
Computerized MIS	... 295
Basic Requirement of Computer Based MIS	... 296
Approaches of MIS Development	... 296
Pre-requisites of an Effective MIS	... 298
Computer and its Effect on MIS	... 300
Impact of Computers and MIS on Corporate Management	... 302
Constraints in Operating a MIS	... 304
Limitations of MIS	... 304
MIS and Data Processing	... 305
MIS and Decision Support Systems (DSS)	... 305
Core Capabilities of DSS	... 306
MIS and Information Resource Management	... 307
Executive Information and Decision Support Systems	... 307
Artificial Intelligence and Expert Systems	... 308
Entrusting MIS in a Corporate Enterprise	... 310
MIS in Indian Organizations	... 311
Enterprise Resource Planning (ERP) Systems	... 312
Characteristics of ERP	... 313
Functions of ERP	... 313
Benefits of ERP Systems	... 314
Managerial Aspect of ERP	... 315
Conclusion	... 315
Lesson Round-Up	... 316
SELF-TEST QUESTIONS	... 317

STUDY VIII
INTERNAL CONTROL SYSTEMS

Learning Objectives	... 319
Introduction	... 319

	<i>Page</i>
Meaning and Definition of Internal Control	... 320
Classification of Internal Control	... 321
Elements of Internal Control	... 323
Characteristics of Effective Internal Control	... 327
Objectives and Scope of Internal Control	... 328
Limitations of Internal Control System	... 329
Techniques of Internal Control	... 329
Internal Check	... 330
Internal Audit	... 332
Flow Charts	... 345
Internal Control Questionnaire	... 348
Inter firm and Intra firm Comparisons	... 351
Audit of Internal Control System	... 356
Lesson Round-Up	... 358
SELF-TEST QUESTIONS	... 359

**PART B
STRATEGIC ALLIANCES**

STUDY IX

NATURE AND SCOPE OF STRATEGIC ALLIANCES

Learning Objectives	... 361
Introduction	... 361
Characteristics of Strategic Alliance	... 362
Trading and Functional Alliances	... 363
Need of Alliances	... 363
Advantages of Alliances	... 364
Strategic Alliances	... 364
Types of Strategic Alliances	... 365
Integrating Alliances into Corporate Strategy	... 366
Preparing for the Alliances	... 367
Cross Cultural Alliances	... 370
Planning the Cross Cultural Alliances	... 371
Understanding Cross Cultural Alliances	... 371
Implementing and Managing the Alliances	... 372
Alliances Checklist	... 374
Lesson Round-Up	... 375
SELF-TEST QUESTIONS	... 376

STUDY X
FOREIGN COLLABORATIONS AND JOINT VENTURES

Learning Objectives	... 377
Introduction	... 377
Industrial Policy Resolution, 1948	... 378
Industrial Policy Resolution, 1956	... 379
Statement on New Industrial Policy, 1991	... 379
Foreign Direct Investment	... 380
Other Modes of Foreign Direct Investments	... 381
Origin of Investment in India	... 381
Types of Investment	... 382
Eligibility of FDI in Resident Entities	... 384
Conditions on issue/transfer of Shares	... 384
Remittance and Repatriation	... 388
Procedure for Foreign Direct Investment	... 389
Foreign Direct Investment Reporting	... 390
Prohibition on Investment in India	... 392
Foreign Collaborations and Joint Ventures	... 392
Joint Venture	... 393
Modes of Joint Venture	... 394
Drafting Joint Venture and Foreign Collaboration Agreements	... 397
Drafting an Agreement	... 397
Important Clauses in Collaboration Agreements	... 398
Arbitration Clause	... 399
Specimen Agreement for Foreign Technical Services in India	... 401
Restrictive Clauses under Foreign Collaboration/Joint Venture Agreements	... 406
Kinds of Restrictive Practices	... 407
Problems Associated with Technology Transfer	... 414
Indian Joint Ventures Abroad	... 415
Direct Investment Outside India	... 416
Investment in Equity of Companies Registered Overseas/ Rated Debt Instrument	... 419
Lesson Round-Up	... 421
SELF-TEST QUESTIONS	... 422

**PART C
INTERNATIONAL TRADE**

STUDY XI

INTERNATIONAL TRADE AND TREATIES

Learning Objectives	...	423
Introduction	...	423
Mercantilism	...	423
Adam Smith's Wealth of Nations	...	424
Comparative Advantage	...	426
Theoretical Challenges to Free Trade	...	427
Institutionalization of International Trade	...	429
Trade Rounds—The Package Route to Progress	...	430
Did GATT Succeed?	...	431
How is the WTO different from GATT?	...	432
Regional Trading Blocks	...	433
Association of South-East Asian Nations (ASEAN)	...	433
European Communities/European Union	...	436
North American Free trade Agreement	...	439
South Asian Association for Regional Co-operation	...	440
South Asian Preferential Trading Area	...	442
South Asian free trade Area	...	442
Lesson Round-Up	...	443
SELF-TEST QUESTIONS	...	443

STUDY XII

WORLD TRADE ORGANISATION (WTO)

Learning Objectives	...	444
Introduction	...	444
Roots from Havana to Marrakesh	...	445
The Uruguay Round	...	446
Doha Ministerial Conference	...	448
World Trade Organization	...	449
Principles of the Trading System	...	451
Trade without Discrimination	...	452
WTO and GATT	...	454

	<i>Page</i>
WTO Agreements—An Overview	... 455
Textiles Monitoring Body (TMB)	... 459
Services : Rules for Growth	... 460
Basic Principles of GATS	... 461
Intellectual Property	... 463
The World Intellectual Property Organisation	... 467
WIPO's Relations with the World Trade Organisation	... 469
Anti-Dumping Subsidies	... 469
Anti-Dumping and Countervailing Duties	... 470
Subsidies and Countervailing Measures	... 471
Non-tariff Barriers	... 473
Agreement on Import Licensing Procedures	... 473
Agreement on Technical Barrier to Trade	... 474
Rules of Origin	... 474
Plurilaterals	... 475
Trade Policy Review	... 475
Settlement of Disputes	... 476
Lesson Round-Up	... 478
SELF-TEST QUESTIONS	... 479

STUDY XIII

WTO – MINISTERIAL CONFERENCES

Learning Objectives	... 480
Introduction	... 480
Singapore Ministerial Conference, 1996	... 481
Role of WTO	... 482
Geneva Ministerial Conference, 1998	... 486
Geneva Ministerial Declaration on Global Electronic Commerce, May 20, 1998	... 487
Seattle Ministerial Conference, 1999	... 487
Doha Ministerial Conference, 2001	... 488
Work Programme	... 489
Cancun Ministerial Conference, 2003	... 493
Hong Kong Ministerial Conference, 2005	... 495
Geneva Ministerial Conference, 2009	... 498
Lesson Round-Up	... 500
SELF-TEST QUESTIONS	... 501

**STUDY XIV
ANTI-DUMPING DUTIES**

Learning Objectives	...	502
Agreement on Implementation of Article VI	...	502
Article VI of Gatt and Anti Dumping Agreement	...	504
Agreement on Implementation of Article VI of the General		
Agreement on tariffs and trade, 1994	...	504
Anti Dumping and Indian Laws	...	509
Determination of Dumping	...	511
Dumping Investigation	...	512
Investigation Process	...	514
Retrospective Measures	...	515
Miscellaneous Provisions	...	515
Products Imported by Units in EPZs/100% EOUs, Advance		
Licence Holders and by other Exporters	...	516
Applicability of Anti-dumping Duties <i>vis-a-vis</i> other Measures	...	516
Institutional Arrangement In India For Anti Dumping, Anti-Subsidy		
And Safeguard Action Against Unfair Trade Practices	...	516
Significance of Anti Dumping Measures in India in the context		
of lifting of quantities restriction	...	516
Lesson Round-Up	...	517
SELF-TEST QUESTIONS	...	518

**STUDY XV
SUBSIDIES AND COUNTERVAILING DUTIES**

Learning Objectives	...	519
Introduction	...	519
Agreement on Subsidies and Countervailing Measures (SCM Agreement)	...	521
Subsidies and CVDs in SCM	...	522
Structure of the Agreement	...	524
Categories of Subsidies	...	526
Countervailing Measures	...	528
Substantive Rules	...	530
Duration and Review of Countervailing Duties	...	530

	<i>Page</i>
Procedural Rules	... 532
Subsidies in Agreement on Agriculture	... 533
Export Subsidy on Agriculture	... 535
Non-trade Concerns and Multifunctionality	... 539
Lesson Round-Up	... 542
SELF-TEST QUESTIONS	... 543
 STUDY XVI SETTLEMENT OF DISPUTES UNDER WORLD TRADE ORGANISATION	
Learning Objectives	... 544
Introduction	... 544
Central Role in the Securities and Predictability of WTO Multilateral Trading System	... 546
Rule-based System	... 546
Preserving the Rights and Obligations of WTO Members	... 548
Dispute Settlement Procedure	... 551
Circumstances and Nature of Consultations or Expert Review Groups	... 556
Task of the Appellate Body: Review on Appeal the Issues of Law Addressed by Panels	... 559
Surveillance and Implementation of Reports	... 560
Conditions for Suspension of Concessions or 562 Other Obligations (Retaliation)	... 562
Role of the Director General	... 563
Lesson Round-Up	... 564
Self-Test Questions	... 565
 TEST PAPER 2011	
Test Paper 1/2011	... 568
Test Paper 2/2011	... 570
Test Paper 3/2011	... 572
Test Paper 4/2011	... 574
Test Paper 5/2011	... 576
QUESTION PAPERS OF TWO PREVIOUS SESSIONS	... 578

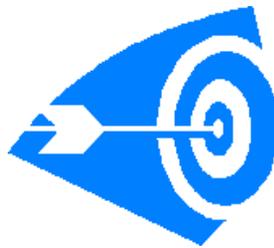
PROFESSIONAL PROGRAMME
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

PART A – STRATEGIC MANAGEMENT

STUDY I

NATURE AND SCOPE OF STRATEGIC MANAGEMENT

LEARNING OBJECTIVES



The object of this study lesson is to enable the students to understand:

- Concept of strategy
- Meaning of strategic management
- Evolution of strategic management
- Role of strategic management in modern organizations
- Functions of strategic management
- Benefits and limitations of strategic management
- Process of strategic management
- Various levels of strategy in organizations
- Issues in strategies for global business
- Strategic issues of knowledge management.

CONCEPT OF STRATEGY

The word strategy has entered the field of management more recently. The word strategy has been derived from Greek word 'Strategos', which means generalship. Firms use the strategic management process to achieve strategic competitiveness and earn above average returns. Strategic competitiveness is achieved when a firm has developed and learned how to implement a value-creating strategy. Above average returns means the returns in excess of what investors expect to earn from other investments with similar levels of risk. It provides the base that a firm needs to satisfy all its stakeholders.

According to Alfred D Chandler management is an art as well as science. Many of the concepts used in building management theory have been derived from

practice. Unlike the pure sciences, which have their foundation in experimental research, management studies draw upon the practical experiences of managers in defining concepts. Business policy is rooted in the practice of management and has passed through different phases before taking its shape in the present form of strategic management. Chandler made a comprehensive analysis of interrelationships among environment, strategy, and organizational structure.

Strategy:



Chandler defined strategy as: *“the determination of the basic long-term goals and objectives of an enterprise and the adoption of the courses of action and the allocation of resources necessary for carrying out these goals.”* It refers to the following three aspects:

- ▶ *Determination of basic long-term goals and objectives,*
- ▶ *Adoption of courses of action to achieve these objectives, and*
- ▶ *Allocation of resources necessary for adopting the courses of action.*

Concept of Strategy as defined by different authors:

Strategy may be defined as: the pattern of objectives, purpose, goals, and the major policies and plans for achieving these goals stated in such a way so as to define what business the company is in or is to be and the kind of company it is or is to be”.
-**Kenneth Andrews**

This definition refers to the ‘business definition’, which is a way of stating the current and desired future position of company, and the objectives, purposes, goals, major policies and plans required to take the company from where it is to where it wants to be.

The concept of strategy is explained as “the common thread among the organization’s activities and product markets... that defines the essential nature of business that the organization was or planned to be in future”.
-**Igor Ansoff**

He stressed on the commonality of approach that exists in diverse organizational activities including the products and markets that define the current and planned nature of business.

Strategy is defined precisely as unified, comprehensive and integrated plan designed to assure that the basic objectives of the enterprise are achieved.

-**William F Glueck**

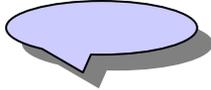
In this ‘unified’ means that the plan joins all the parts of an enterprise together; ‘comprehensive’ means it covers all the major aspects of the enterprise, and ‘integrated’ means that all parts of the plan are compatible with each other.

Henry Mintzberg advocates the idea that strategies are not always the outcome of rational planning. They can emerge from what an organization does without any formal plan. He defines strategy as: “a pattern in a stream of decisions and actions”. Mintzberg distinguishes between intended strategies and emergent strategies. Intended strategies refer to the plans that managers develop, while emergent

strategies are the actions that actually take place over a period of time. In this manner, an organization may start with a deliberate design of strategy and end up with another form of strategy that is actually realized.

Based on the various views of the term strategy, it is defined as a long –term course of action through which an organization deploys its resources so as to achieve its objectives.

The features of strategy can be summarized as follows:



- (i) *Strategy is a relative combination of actions aimed at to meet a particular condition to solve certain problems, or to achieve a desirable end.*
- (ii) *Strategy is a major course of action through which an organization tries to relate itself with environment to develop certain advantages which help in achieving its objectives.*
- (iii) *Strategy may involve contradictory action. As the strategic action depends on environmental variables, an organization may take contradictory actions either simultaneously or with a gap of time.*
- (iv) *Strategy is forward looking and it has orientation towards future. Strategic action is required in a new situation.*

Illustration:

Tata motors is launching its small car i.e. Nano as a part of its strategy to tap the vast low end market and to provide a safer and more convenient vehicles to the users of two wheelers.

Strategies are always the outcome of rational planning?

Strategies are not always the outcome of rational planning, they emerge from what an organization does without any formal plan.



LEVELS OF STRATEGY

The strategic planning process culminates into formulation of strategies for the organization. A business strategy must contain well coordinated action programme aimed at securing a long-term competitive edge and which should be sustained by the company.

The following are the three broad levels of strategy:

(i) Corporate-Level Strategy

In an organization there are basically three levels. The top level of the organization consists of Executive Officer of the company, the Board of Directors and administrative officers, the responsibility of the top management is to keep the

organization healthy. The issue pertaining to business ethics, integrity and social commitments etc. are dealt with at this level of strategic decisions. Major financial policy decisions involving acquisition, diversification and structural redesigning etc. belong to the category of corporate level strategy. Corporate level strategies translate to orientation of the shareholders and the society into the forms of strategies for functional or business levels. The nature of strategic decision in the corporate level tends to be value oriented and conceptual. There is also greater risk, cost and profit potential as well as greater need for flexibility associated with corporate level strategic activities. Further, the content of corporate-level strategy is a set of action plans for corresponding corporate-level goals.

The substance of corporate-level goals and action plans can be summarized as follows:

- ▶ Corporate-level goals: It is the desired portfolio of business units by the end of the firm's planning period.
- ▶ Corporate-level action plans: It discusses, how to get from the present portfolio to that targeted in (1) in terms of—
 - (a) business unit strategies to be retained.
 - (b) additions of business units expressed as either growth strategy parameters or merger and acquisition strategy.
 - (c) business units to be divested.

A company's portfolio of business units (strategic business units) can vary in its desirability just as a financial manager's portfolio of investments. The acceptability of a particular business portfolio is determined by assessing whether it reflects mission and expected strengths, weaknesses, threats, and opportunities (determined through environmental, industry, and internal analysis of each business unit) as well as values and political exigencies. Additions to and deletions from the present portfolio would then be expressed in merger and/or divestment strategy. Finally, these strategies would be implemented by the appropriate organizational units and the machinery would thus be activated to adjust the present portfolio. It is due to corporate strategy of focusing on heavy and high tech industries that Tata group has sold off its soap and oil business to Hindustan Uniliver.

(ii) Business-Level Strategy

Business or divisional level strategy usually occurs at business unit or product level and it emphasizes improvement of the competitive position of a company's product or services in the specific industry or market segment served by that business unit. Business strategies, most often are concerned with maintaining or increasing market share.

Business level management consists of primarily the business managers or managers of strategic business units. The managers at this level translate the general statements of direction intent whisked out at corporate level. The corporate values, managerial capabilities, organizational responsibilities and administrative systems that link strategic and operational decisional making stage at all the levels of hierarchy, encompassing all business and functional lines of authority in a company

are dealt with at this level of strategy formulation. Strategic decisions at business level should include policies involving new product development, marketing mix, research development, personnel, etc. Thus, the content of business-level strategy is a combination of goals and action plans.

(iii) Functional-Level Strategy

Functional level strategy involves decision making with respect to specific functional areas, say, production, marketing, personnel, finance, etc. Decisions at the functional level are often described as tactical decisions. Functional strategies emphasize on doing things correctly. But these decisions are guided by overall strategic considerations and must be consistent with the frame work of the business strategy.

Functional strategy is the approach taken by functional area to achieve corporate and business objectives and maximizing resource productivity.

- T.H. Wheelen and S. David Hemger

Functional Strategy is concerned with developing and nurturing a distinct competence to provide a company or business unit with a competitive advantage. In contrast with the other levels of strategy, functional strategies serve as guidelines for the employees of each of the firm's sub-divisions. Which segments or functional areas are included in a firm's functional strategy set is itself a matter of strategy. For example, whether to have an R&D department or not in the first place is a strategic decision. Functional goals and action plans are developed for each of the functional areas of the firm to guide the behavior of people in a way that would put the other strategies into motion. If part of a firm's business-level strategy is to target 10 percent increase in sales to be brought about by market penetration, marketing strategy might include a change in compensation policy for sales persons and a specified increase in the advertising budget. In that way, marketing strategy would provide the details about how the marketing aspects of the market penetration action plan would be implemented. Similarly, financial strategy would consist of a set of guidelines on how the financial elements of the firm would be put into effect. Personal strategy, production strategy, research and development strategy, and other appropriate functional strategy areas would do the same.

DELIBERATENESS OF STRATEGY

Sometimes outsiders impute strategy to the behavior of firms. Obviously, students analyzing case studies are placed in this position when they impute strategy from the data they are able to generate on the firm's operations. Similarly, journalists and the managers of competing firms may impute strategy to a firm's behavior; and it may or may not accurately reflect the real strategy in place.

Mintzberg developed a taxonomy which is useful for discussing the realism and deliberateness of strategy. First, he distinguished between strategy that is the result of a plan, and of a pattern of behavior. He referred strategy as plan and strategy as pattern. Strategy as plan is a chosen course of action; it could be a real strategy (one intended for implementation) or a ploy (a tactical move whereby a competitor may be influenced into making a mistake).

Illustration:

Some people think that Coca-Cola's rumoured change in Coke's formula in the mid-1980s was such a ploy. The implication is that Coca-Cola had not intended to really change the formula. Instead, they publicized their plan to change formula, introduced a new product with a different formula that tasted a lot like a competitor's product, and finally graciously conceded to continue producing the old formula product when the public demonstrated a preference for it over the new—"similar to a competitor's—" formula. (Incidentally, this was in fact a ploy, it was to rank among the top by any business. Coca-Cola reaped an immediate increase in market share of about 15 percent that thrust them once again into unquestioned dominance in the huge U.S. soft drink market).

Strategy as plan, when implemented, may or may not be what the firm ends up with. The planned strategy could ultimately be either realized or unrealized. If it is realized, then the entire process would be a textbook case of strategy formulation and implementation in the sense that the firm successfully implemented.

But what happens if the planned strategy is implemented and, for some reason, the strategy that is realized is not the intended one? We might say that the planned strategy was unrealized, and the realized strategy (the one that seems to describe what the company is actually doing) arises out of some consistency in the behavior of the company. It is called as unintended realized strategy i.e. strategy as pattern, or a pattern in a series of actions by the organization. Strategy as pattern is what you will end up with when you impute strategy to the behavior of a company you are analyzing in a case study, or what journalists produce when they attribute a strategy to a company based only on its actions.

A realized strategy could be either a deliberate strategy as plan, or an undeliberate strategy as pattern. If the realized strategy was planned and also accurately described the firm's actions, then strategy as pattern and strategy as plan would be synonymous. However, when realized strategy is not intended strategy (that is, it was neither what was intended by management when they drafted a planned strategy nor they drafted a strategy at all), then it simply developed out of the activities of the company. It emerged as a pattern of behavior in the absence of intention, or despite unrealized intentions.

Often it is convenient to distinguish between intended and emergent strategies. When management performs no strategic management at all, they still have a realized strategy that is emergent. This emergent strategy could be recognized by outsiders (and insiders for that matter) even though it may not have been intended by management.

Managers may develop several versions of strategy, each of which is intended to fit a different environmental scenario. An environmental scenario consists of a set of environmental characteristics that describe a firm's external circumstances. By structuring external variables into sets of related variables, different scenarios are resulted. A strategy set is established for each scenario. These could be entirely different strategies or variations of one another. Then evaluative criteria are formulated for each scenario. These are variables to be monitored in order to figure out which of the scenarios is going to apply in the future. Actually this is a matter of

deciding whether the present scenario will continue to be the best description of the firm's environment or, instead, one of the others seems to be emerging as most correct. By identifying critical values for evaluative criteria, the strategist knows beforehand under what set of conditions to switch from the present strategy set to the pessimistic or optimistic set.

STRATEGIC MANAGEMENT

Strategic management is the art and science of formulating, implementing and evaluating cross-functional decisions that will enable an organization to achieve its objectives. It is the process of specifying the organization's objectives, developing policies and plans to achieve these objectives, and allocating resources to implement the policies and plans to achieve the organization's objectives. Strategic management, therefore, combines the activities of the various functional areas of a business to achieve organizational objectives. It is the highest level of managerial activity, usually formulated by the Board of directors and performed by the organization's Chief Executive Officer (CEO) and his executive team. Strategic management provides overall direction to the enterprise.

Strategic management does not replace traditional management activities such as budgeting, planning, monitoring, marketing, reporting, and controlling. Rather, it integrates them into a broader context, taking into account the external environment, internal organizational capabilities, and organization's overall purpose and direction.

Strategic management emphasises innovative strategic programme and looks for changes, makes a critical appraisal of its own management conception and practice and by searching for and implementing innovative strategies. **-Ansof**

Strategic management is defined as a set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of an institution. **-John and Richard**

Thus, strategic management is an ongoing process that assesses the business environment and the industries in which the company is involved; its competitors and sets goals and strategies to meet all existing and potential competitors; and then reassesses each strategy annually or quarterly i.e. regularly to determine how it has been implemented and whether it has succeeded or needs replacement by a new strategy to meet changed circumstances, new technology, new competitors, a new economic environment., or a new social, financial, or political environment.

Strategic management is, in large part, a decision-making activity. The strategy of an organization is the result of a series of managerial decisions. Although these decisions are often supported by a great deal of quantifiable data, strategic decisions are fundamentally judgmental. Because strategic decisions cannot always be quantified, managers must rely on 'informed judgement' in making this type of decision. As in our own lives generally, the more important the decision, the less quantifiable it is and the more we will have to rely on the options of others and our own best judgement. For example, our most important personal decisions-where to attend college, whether to get married, and so on, are largely judgements. Similarly, the most important organizational decisions, such as entering a market, introducing a new service, or acquiring a competitor, although based on information and analysis, are essentially judgements.

Illustration: A Case Study of WalMart**Introduction**

In any organization, strategy management is the key to its success. Without a proper strategy, it is difficult for any industry to survive irrespective of its size. Success of most of the major corporate organizations can be attributed to superior strategic planning and implementation. The same is true of WalMart, the largest retail company in the history of world. The case described herein lays bare some of the significant aspects of WalMart's strategic management.

Strategic decisions are those that differentiate an organization from its competitors in a way that is sustainable in future. Porter has advocated that a business decision can be classified as strategic if it involves some innovation and difference that results in sustainable advantage.

WalMart's Business Model

By 2002, WalMart had over 12 lakh employees with growth rate of 11.2%. It operates 4150 retail facilities globally. The key components of the Wal-Mart strategy includes firm infrastructure like frugal culture, no regional offices and pleasant work environment. WalMart terms its employees as associates. Manager compensation is linked to profit of store operated by him. The workforce of the company is not unionized. Technology being vital to an organization, WalMart is well equipped with technological innovations like POS, store performance tracking, real time market research and satellite system. Procurement measures like hard nosed negotiations, centralized buying, planning packets, etc. helps achieve the goal of providing goods and services on cheap prices. The other factors that increase the margin of profit for Wal-Mart are inbound logistics, with frequent replenishment, automated DCs cross docking, pick to flight, hub and spoke system. It has big stores in small towns with monopoly in the market at low rental costs, local prices, concentric expansion, merchandising in brand name, private labels, little space for inventory and store within store. Less is spent on advertising and prices are fixed low. All these factors combine to increase the profit margin through bulk sales.

WalMart Strategy

Dominance of WalMart in retailing is due to a number of factors like its business model which is still a mystery and not letting its competitors know of its weaknesses. It thrives on three generic strategies consisting of Focus strategy, Differentiation strategy and Overall Cost Leadership. It has firm infrastructure, well equipped human resources and technological superiority. The company is financially very strong and is capable of standing still in time of crisis. WalMart operates on low price strategy operated as every day low prices (EDLP) which builds trust among the customers. It sells at lower price but increases profits by increasing the volume. This ferociously increases the competition in the market and WalMart competes with all its competitors till it is dominant in the market.

WalMart has taken over many international as well as domestic stores. For instance, it took over 122 Woolco stores in Canada, 21 Wertkauf stores in Germany and 229 ASDA units in the UK. The takeover strategy keeps the company at forefront as well as minimizes the number of competitors. The company has made dramatic impact since 1962 when Sam Walton first started his business through its low cost and over expanding strategy.

Sustainability in Discount Retailing

WalMart makes the consumers addicted by convincing them that its prices are lower than the other stores. It does so by advertising that "We have lower prices than anyone else" and placing a "opening price point". The opening price point is the lowest price in the store which is kept at high visibility which makes consumers believes that products in this store are really cheaper. With its visionary goal of attaining zero waste status and reaching 100% renewable energy has planned to launch a number of sustainability initiatives such as Imitation (increasing profits by increasing the supply), Substitution (reducing demand for what a firm usually provides by shifting the demand elsewhere) and Hold-up (diverting value to customers, suppliers or complementors who have some bargaining leverage resulting in tough negotiations and vertical integration).

Through the aforementioned strategic management techniques, WalMart has succeeded in developing network of 7800 stores, employing 2 million associates and serving more than 100 million customers every year.

Source: *Crafting and Executing Strategy: Concepts & Cases. Thomson, Arthur. A et.al.*

EVOLUTION OF STRATEGIC MANAGEMENT

McKinsey analysis discovered four quite distinct phases of strategic management evolution.

In Phase 1, financial planning, management focuses on the preparation of budgets with an emphasis on functional operations. Most organizations have a budgeting process, in at least rudimentary form, as a way of allocating resources among functional units, subsidiaries, or projects. Forecast-based planning follows the managers to project budget requirements beyond the one-year cycle. This phase represents an effort to extend managers' attention beyond the immediate future as scenarios are developed which describe their expectations about future time periods. Budgets are often constructed for several years at a time and are rolled over annually so that the appropriateness of a budgeted amount can be reviewed several times before it is operationalized.

In Phase 2, planning is very "now" oriented. Current operations and characteristics are stressed in analysis of the firm and there is little attention to or patience for considering operational options or development of strategic changes. The business portfolio in Phase 2 is often viewed as the final expression of strategy rather than as an input to the strategy formulation process. Current structure and business activities may be considered not as strategic variables.

In Phase 3, external oriented planning, requires a significant change in management viewpoint. Planners are required to adopt an external orientation and tools and procedures for environmental and internal assessment. Concern arises in understanding the organization's environment and competitive position and generating ideas about how the company might better fit in its environment. Several choices, contingency plans, are often devised for this. Lower level planners and managers are often involved in the process of generating choices, an activity that soon puts top management in the position of choosing a plan in which it had little involvement in developing.

In Phase 4, strategic management evolves as top management and senses the need to more heavily invest in the planning process because of its lack of understanding of or involvement in the details of earlier plan development. Strategic management is the meshing of Phase 3 planning and operational management into one process.

Strategic management as a way of thinking

Strategic management is a philosophy – a way of thinking. It is an intellectual process. Strategic management requires a broad base of leadership throughout the organization and asks everyone to think as a leader. In a strategic context, this process is called strategic thinking. Vision and a sense of the future are an inherent part of strategic management. Strategic thinkers are constantly reinventing the future – creating windows on the world of tomorrow. All enterprises or projects, big or small, begin in the mind's eye; they begin with imagination and with the belief that what is merely an image can one day be made real. Strategic thinkers draw upon the past, understand the present, and can envision a better future.

vision and sense of the future are an inherent part of strategic management?

This statement is correct as strategies are constantly reinventing the future creating windows on the world of tomorrow vision and a sense of the future are an inherent part of strategic management.



Strategic Thinkers vs. Planners

Strategic thinkers have built and continue to build systems that will serve the organization during the next 50 years. Strategic thinkers are visionaries. They know what they want to become and what they want their organizations to be. Strategic thinkers look at assumptions, understand system interrelationships, create scenarios, and calculate the odds. Strategic thinkers forecast external technological and demographic changes, as well as critical changes in the political and regulatory arenas. Planners, on the other hand, figure out how to get where the strategic thinkers want to go. A planner gathers and evaluates data and tells the strategic thinker what it will take to achieve the objective.

Strategic thinking, therefore, is an important foundation of strategic management. However, leadership is not confined to just the CEO or the top level of the organization. Leadership is a performing art – a collection of practices and behaviors – not a position. For strategic management to be successful, everyone should be

encouraged to think strategically, encouraged to be a leader. Such thinking is facilitated through a model of the process and an understanding of the possible approaches to strategic management.

NATURE OF STRATEGIC DECISIONS AND STRATEGIC THINKING

The process of creating strategy is often discussed as if it was an unconstrained design process, and strategists evaluate strategy, when the firm is operating. This evaluation involves assessing the extent to which present strategy is meeting expectations. It may be the case that only a small part of, say marketing strategy would have to be changed to correct a problem. In effect, then, such a change would constitute an acceptance of corporate- and business-level strategy, and also of the firm's functional strategy set. When a firm's performance is less than satisfactory, the reason often is a functional strategy shortcoming. One might say that a good business-level strategy would have been poorly implemented by part of its functional strategy set. For example, a change in marketing strategy could improve performance while other levels of strategy would remain unchanged.

Alternatively, a problem with the nature of a business brought about by a major environmental opportunity or threat, a change in the goals set, or development of some internal capability or weakness could necessitate a business-level strategy change. The new strategy would probably include vestiges of the old along with some unfamiliar elements. In most cases a whole new functional strategy set would likely have to be designed and put into effect to implement the new business-level strategy.

Generally, one could conceivably change parts of a firm's functional set strategy without changing business-level strategy. However, rarely one would expect to encounter the case in which a change in business-level strategy did not trigger the necessity to alter functional-level strategy in some way, at least not in a successfully managed business.

There is a risk of incorrectly identifying the strategy level at which a problem exists. A tendency exists in business to change functional-level strategies or organizational structure in an attempt to remedy any problem. Of course, if the problem existed within the firm's corporate-or business-level strategy, then changing functional-level strategy would not correct it. In fact, this move would most likely aggravate the situation. The reason for this tendency is probably that functional strategy changes are potentially less disruptive than changes in the other levels. They certainly would affect fewer people than modifications at the corporate or business levels.

Strategic decisions are those which involve clear and favorable differentiation from competitors, so that one's competitive advantage is tangible, measurable, and preservable. Defining strategic thinking is made especially difficult by the absence of a consensus on what strategic management is. The explanation of strategic management is that it is an approach to management which fuses strategic planning (plan development through analysis of environment, competition, and strategy choices) and the firm's system of operational decision making.

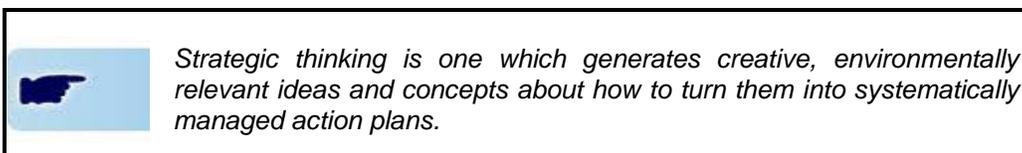
This process has five dimensions.

- (i) Strategic management requires a widely understood strategic planning

process tightly interwoven with a strategically centered organization structure.

- (ii) It requires widely discussed, analyzed and negotiated goal choices from which are culled out the ones that are not adoptable.
- (iii) Strategic management relies on the shared ability to think strategically by managers throughout the company.
- (iv) A performance evaluation system is necessary that focuses top level evaluators' attention on critical, positive and negative strategic factors.
- (v) It requires a strategy supportive motivational system and value orientation among managers.

These qualities, they say, define a strategically managed organization.



It has the following pre-requisites:

1. Input information is based on facts and logical data,
2. Previously unquestioned assumptions are sought out and examined,
3. A burning desire for resource conservation, and
4. Indirect, spontaneous, and unexpected thought processes which are hard for competitors to predict.

These requirements of strategic thinking set it apart from other kinds of decision making.

- (i) Strategic thinking requires factual and logical input data because it is competitively dangerous to base strategy formulation on erroneous information.
- (ii) Long-held assumptions should be identified and analyzed to make sure they still apply. This is especially true about goals which are in force, understandings about the environment and competitors, market acceptance and image, etc.
- (iii) The manager attempting to think strategically should be committed to conservation of the organization's resources rather than expecting that a good idea will precipitate a cornucopia of funds, people, and support. It is easy to be creative while assuming that most resource requirements can be taken care of. A greater degree of creativity is required when one must conserve resources.
- (iv) Strategic thinking must be done without setting patterns which competitors can identify and anticipate.

ROLE OF STRATEGIC MANAGEMENT

Studies have revealed that organizations following strategic management have

outperformed those that do not. Strategic planning ensures a rational allocation of resources and improves co-ordination between various divisions of the organization. It helps managers to think ahead and anticipate problems before they occur. The main benefit of the planning process is a continuous dialogue about the organization's future between the hierarchical levels in the organization.

In short, the most highly rated roles of strategic management in an organization are:

- Clarity of strategic vision for the organization.
- Focus on what is strategically important to the organization.
- Better understanding of the rapidly changing business environment.

Strategic management need not always be a formal process. It can begin with answering a few simple questions:

1. Where are we now?
2. If no changes are made, where we will be in the next one year? Next two years? Next three years? Next five years? Are the answers acceptable?

If the answers are not acceptable, what actions should the top management take? With what results and payoffs?

Today, businesses are becoming more complex due to rapid changes in environment. It is becoming increasingly difficult to predict the environment accurately. The internal and external environments of organizations are now driven by multitudes of forces that were hitherto non-existent. Earlier, the changes in technology were not so rapid but today the information from all over the globe is pouring in through the computers. The world in fact has shrunk. This has created fierce competition as the customers and stakeholders have become more aware of their rights.

The number of events that affect domestic and world market are now far too many and too often. Over reliance on experience in such situations may really work out to be very costly for companies.

Illustration 1:

Reliance has shifted to more creativity, innovation and new ways of looking at business and doing it in novel ways. The earlier concepts of having highly specialized departments and developing specialization of labour is losing its credibility. Organizations are becoming more responsive, flexible, and adaptable to changing business situations. In such an environments that are charged with high level of competition, developing competitive edge for survival and growth has become imperative for companies.

Illustration 2:

ITC began a tobacco company. Over the years, it has diversified into paper (ITC Bhadrachalam), hotels (Welcome Group), food (ITC Agro), and garments (Wills Lifestyle) in order to take advantage of changing environments and to achieve its growth objectives.

FUNCTIONS OF STRATEGIC MANAGEMENT

Strategic management is an externally oriented philosophy of managing an organization that links strategic thinking and analysis to organizational action. As an explicit philosophy of managing an organization, strategic management discharge the following functions:

- provides a framework for thinking about the business;
- creates a fit between the organization and its external environment;
- provides a process of coping with change and organizational renewal;
- fosters anticipation, innovation, and excellence;
- facilitates consistent decision making;
- creates organizational focus; and
- facilitates the process of organizational leadership.

Strategic management provides an ongoing structure for rationally thinking about the plans and actions of the organization. It attempts to orchestrate a fit between the organization's external environment (political, regulatory, economic, technological, social, and competitive forces) and its internal situation (culture, organization structure, resources, services, and so on). In some cases this may mean responding to external forces, whereas in other cases the organization may attempt to actually shape its environment (change the rules for success). At any rate, external change is inevitable, often the shifts may be subtle; sometimes they can be discontinuous and extremely disruptive. When such changes occur, new opportunities emerge and new competencies are born, while others die or are rendered inconsequential. Inevitably, the basic rules of competing and survival will change.

Strategic management is an organization's mechanism for understanding and constructively managing change and the process for reinventing or renewing the organization. Strategic management is both externally and internally oriented. It focuses on anticipating external change, fostering innovation in the services and processes of the organization, and promoting excellence. At the same time, strategic management sets direction for the organization and through a common understanding of the vision and broad goals provides everyone in the organization a template for making consistent decisions. The process of strategic management defines where the organization is going and, sometimes more importantly, where it is not going. It creates organizational definition and focus.

Strategic management has become an integral part of the philosophy of senior leadership of organizations and is no longer viewed as a separate discipline. As Max DePree has suggested, "leaders are obligated to provide and maintain momentum". Although organizations may accomplish superior results for a brief period of time, it takes the orchestration of management as well as leadership to perpetuate these capabilities far into the future. Strategic thinkers constantly relate the organization to its external environment, not just to ensure compatibility and survival, but also to understand or alter the environmental trends well enough to create the future. Thus, it represents a moving and flowing process of analysis and evaluation to continuously monitor the environment and adapt the organization. Strategic management is the process of organizational leadership.

BENEFITS OF STRATEGIC MANAGEMENT

Strategic Management broadly offers the following benefits:

(i) Clarity in Objectives and Direction: Strategic Management with clarity in objectives provide clear direction to persons in the organization who are responsible for implementing the various courses of action. It has been realised that persons perform better if they know clearly what they are expected to do and where their organization is going.

(ii) Improvement in Financial benefits of Organization: Effective and sound strategic management in an organization results in improvements in financial benefits to the organizations in the form of increased profits and sales revenue. Available empirical studies and logical analysis conducted by the experts so far have confirmed that the financial performance of those companies which have adopted strategic management approach was comparatively better than those companies which did not adopt strategic management approach. It is because of simple reason that company which adopted strategic management are placed in better position to realign their strategies according to the need of external environment including threat and opportunities quickly than those which do not follow this approach.

(iii) Offsetting Environmental Uncertainty: Environmental uncertainty is the important variable which influences the performance, survival and the growth of an organization. Strategic management thus helps to overcome environmental uncertainty by prescribing the future course of action in the light of various forecasts made by the organization. Forecasting and strategic planning are the basic core of strategic management and these provide a clue about what is likely to happen in future. Thus, strategic management process though cannot check the happenings of the future, but it can provide an organization enough time to consolidate its strength to face the challenge with confidence and manage the situation. Strategic management process, enables the top management of an organization to provide rational direction and control for its success. In a way, it enables the organization to innovate in time to take advantage of emerging opportunities in the environment and reduces its risk because it anticipates the future.

(iv) Organisational Effectiveness: Strategic management results in organisational effectiveness in terms of achieving its objectives within the given resources. It may be noted that effectiveness, not only means that resources are put to optimal efficiency but also they are put in a way which ensures their maximum contribution to the achievement of organizational objectives.

(v) Motivation and Satisfaction: Strategic management contributes towards employees motivation and satisfaction by providing them opportunity for participation in decision-making forums. Participation of employees or their representatives in strategy formulation leads to better understanding and clarity of the priority of objectives and operation of compensation system. It also leads to appreciation on their part of the productivity reward linkage inherent in the strategic plan. Strategic management also helps to control the resistance to change by the employees because of greater awareness on the basis of choosing a particular option and limit to available alternatives.

(vi) Improved Quality of Decisions: Strategic management process encourages group interaction for decision-making. It facilitates to workout generation of alternative strategies and better screening of options due to specialized exposures of group members. This enables the organization to choose and act on the best available alternatives.

(vii) Discipline: Strategic management brings discipline in the organisation in terms of effective use of manager's time. It induces a logical thinking process dovetailed with tasks that are scheduled, thus raising vision of all managers in the organisation. They are effectively equipped to focus their energy on strategic directions of growth.

LIMITATIONS OF STRATEGIC MANAGEMENT

Strategic management, in spite of recognized benefits to the organization, is not free from limitations. Some of the important limitations are discussed as under:

(i) Uncertain Predictions: Business units are operating in very complex, competitive and dynamic environment. Strategic management, thus, helps to overcome this problem by making trend predictions and framing strategies accordingly. But practically this has become a serious limitation on effective strategic management. Due to increasing complexity and an accelerating rate of change, it becomes more and more difficult to predict the future outcome with certainty i.e. in terms of government policies, regulatory measures, change in technical know-how, global scenario and political conditions etc. Thus, under these conditions, strategic management is very difficult, time consuming and costly exercise. In spite all this, the role of strategic management business cannot be ignored or overlooked.

(ii) Non-Flexibility: It has been advocated by experts that strategic - management brings non flexibility in the organization through strategic planning. It may be a more serious limitation of strategic management. Strategies are selected and implemented in a given set of environment both external as well as internal. The organization sets out various parameters for its working, for example, designing of organization structure, prescribing rules and procedures, allocating resources, etc. after taking in to account both internal and external factors. In a situation when business unit wants certain change in the light of change in the environment, it becomes difficult. Thus, this internal rigidity - human and procedural may make the strategic planning ineffective and unsound.

However, firm can overcome this problem by building enough flexibility in the system through an open-systems approach of strategic management.

(iii) Contribution of Strategic Management: Another limitation of strategic management is a situation when the managers in the organization are inadequately aware about its contribution to the success of the organization objectives and the way in which strategic management can be undertaken. It has been observed that managers, generally focus their attention on operating problems, ignore more important strategic problems. It is because they are more interested in short-term results.

(iv) Implementation: The most important limitation of strategic management for a business unit is its implementation. Implementation of policies and strategies is concerned with design and management of systems to achieve the best integration of people, structure, processes and resources in reaching organizational purposes. Implementation basically involves number of interrelated decisions, choices and broad range of activities. It requires the commitment and cooperation of all units, levels and members if it is to succeed.

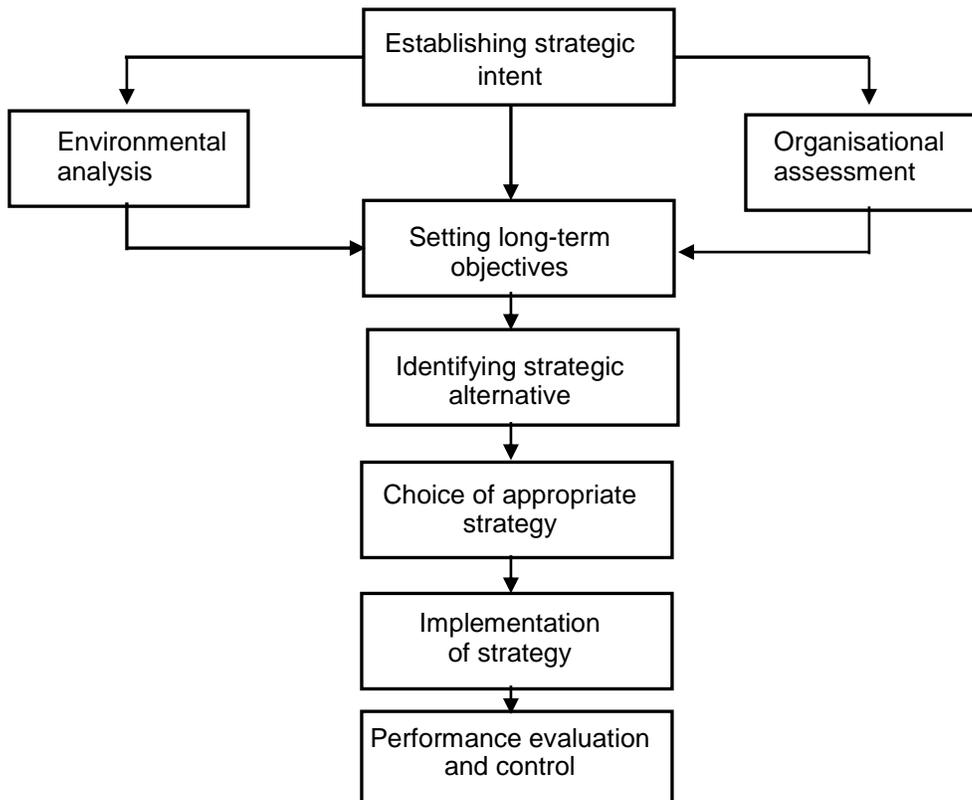
Implementation becomes difficult when there exist conflicting situation among

different departments and groups. It has been observed that all the problems in the organization can not be solved with the help of strategic management but requires use of other aspects of management. For example, the internal conflicts among departments, individuals, or organizational and personal values cannot be solved by strategic management. In many of these cases, non-strategic management functions are more important.

Thus, all these limitations of strategic management should be weighed in the light of its contributions to the success of the organization. Every action has certain limitations but it does not mean that action should not be taken. The recognition of various limitations of an action provides an opportunity to safeguard oneself against the possible counter-effect of the action and places the individual in a better way to make the action more effective.

STRATEGIC MANAGEMENT PROCESS

Strategic management process can be described as a set of managerial decisions and actions which determines the long run direction and performance of the organisation. Normally, the model of strategic management process contains the following elements or stages, such as setting organizational mission and developing objectives, environmental analysis, organisational assessment, identification of strategic alternatives, and choice of appropriate strategy, implementation of strategy and performance evaluation. The process of strategic management can be shown as below:



A brief description of the above steps are discussed below:

(i) Setting Organizational Mission and Objectives

Organisations are deliberate creations and have a definite mission towards which all efforts, energies and resources are directed. In strategic management, this includes strategic intent which consists of vision, mission, values and objectives of an organisation. Vision involves seeing the optimal future. It is the description of the organization in the long run. It is the overall organizational goal which all business activities and processes should achieve. Vision, to be precise, is that view of the future that management believes is optimum for the organization ideally, based on the understanding of external opportunities and threats and internal strengths and weaknesses and communicated throughout the organization. Vision profiles the future and constitutes what the organization wants to do. The mission of an organization is the fundamental unique purpose that sets it apart from other organizations and identifies the scope of its operation. The mission is an enduring statement of organization's intention. It implies the image which the organization seeks to project.

Organization's mission becomes the cornerstone for strategic management and around it all functions revolve. The mission often is expressed in the form of a mission statement, which conveys a sense of purpose to employees and projects a company image to the customers. The values of an organization are fundamental beliefs or truths that it hold dear. Values are the best indicator of the philosophy of the organization and specify what is important (honesty, integrity, customers and so on) in the organization. Values are sometimes referred to as guiding principles. Organizational objectives are long term objectives which serve as the goals for management in achieving the organizational mission. These are the end results which an organization aims to achieve. The objectives should be challenging but achievable. They should also be measurable so that the company can monitor its progress and make corrections as needed. Organizational objectives are other factors which determine the strategy. The choice of the objectives of an organization is a strategic decision because by choosing its objectives, the organization commits itself for these. Thus, vision, mission, values and objectives are considered part of situational analysis because they rely on and influence external and internal environment analysis. It provides broadest direction to the organization.

(ii) Environmental Analysis

A key premise of strategic management is that plans must be made on the basis of what has happened, is happening, and will happen in the world outside the organization with a focus on the threats and opportunities these external changes present to the organization. As already stated, the external environment includes social, technological, economic, environmental, and political trends and developments. This analysis will have implications for organizational change and development. No business can operate in vacuum. An organization being a part of the environment is subject to influence of different variables and influence the environment. Environmental analysis consists of both internal and external analysis. It is the process by which organizations comprehends various

environmental factors and determines the opportunities and threats that are provided by these factors.

Environmental analysis consists of internal analysis and not external analysis:

True/False

False

Environmental analysis consists of both internal and external analysis.



(iii) Organisational Assessment

Why the organization has succeeded in the past, what it will take to succeed in the future, and how it must change to acquire the necessary capabilities to succeed now in the present are issues to be analysed at this stage. For this purpose it is desired to:

- (i) evaluate the organization's capacities--its management, program operations,
- (ii) evaluate the organization's resources--people, money, facilities, technology, and information,
- (iii) review the organization's current capacities and future needs,
- (iv) compile a list of the strengths and weaknesses that will have the greatest influence on the organization's ability to capitalize on opportunities.

(iv) Identification of Strategic Alternative

Interactions of organization with its environment in the light of its strengths and weaknesses will result in various strategic alternatives. This process may result in large number of alternatives through which an organization can relate itself to environment. In fact, all alternatives can not be chosen even if all of them produce the same results. Managers may like to limit themselves to the consideration of some of the alternatives strategies so that they are comfortable with their action. Strategic alternatives should be identified in the light of strategic opportunities and threats generated through environmental analysis.

The process of generating alternatives is a complicated and tedious exercise. If alternatives are more, there is a likelihood of generating good quality solutions. The alternatives may be such that – alternatives which argue for status quo, alternatives which aim at raising revenues or lowering costs, alternatives which can alter the stakeholders' power and objectives, alternatives which come through unconventional wisdom, etc. Each of these types of strategic alternatives holds a number of actions open to the strategic manager.

The following criteria are used to identify crucial strategic issues:

- (a) The impact they could have on the organization,
- (b) The likelihood that they will materialize, and
- (c) The time frame over which they could develop.

The objective of identification of the strategic alternatives is to ensure that the organization's vision and goals:

- are compatible with the organization's capabilities and complement its culture;
- foster commitment and cooperation among key constituencies;
- maximize the benefits inherent in environmental opportunities and minimize the liabilities inherent in environmental threats;
- enhance the organization's position relative to critical success factors (i.e., those organizational elements that distinguish success from failure) and its ability to achieve stated goals.

(v) Choice of Appropriate Strategy

It is the stage of strategic decision process. It consists of identifying the various alternatives and choosing the most appropriate and acceptable one. Once the alternatives are available the next step is to choose the right strategy to tackle the situation. Strategy formulation is the result of making strategic decisions that determine a given strategy. A given strategy is to influence organization's operation in any predetermined manner; the process of choice scientifically takes note of how each alternative strategy affects the variant critical factors that determine the working of the company. A chosen alternative should be suitable to the objectives of the company. The choice of a final strategy from alternatives should be broad based. It means more alternatives should be generated to face the existing situation and the best out of this should only become the strategy.

(vi) Implementation of Strategy

Strategy implementation is the process by which strategies and policies are put into action through the developments of programs, budgets and procedures. A program is a statement of activities to accomplish single use plan. It makes the strategy action oriented. It may involve restructuring the corporation, changing the company's internal culture or beginning a new research effort. A budget is a statement of company's program in terms of financial resources used in planning and control. A budget lists the detailed cost of each program. Many companies demand a certain percentage of return on investment, before management will approve new program. This ensures that new program will significantly add to the company's profit performance and thus build shareholders value. The budget thus not only serves as a detailed plan of new strategy in action, it also specifies through proforma financial statements, the expected impact on the firm's financial future. Procedure, are systems of sequential steps or techniques that describe in details, how a particular task or job is to be done. They typically specify the various activities that must be carried out to complete the company's program.

Thus strategy implementation is the step which leads to achievement of organizational objectives. Implementation of strategy is the real use of the formulated strategy. To implement a strategy, it needs to be translated into a more understandable form. The strategy must be understood at the functional level to be successful. If the lower level misunderstands the strategy, it will be resisted from being implemented.

Strategic management is more than just developing strategic plans. It involves managing the organization strategically. From day to day, leaders must manage the organization so that its strategic plans are implemented. Implementing strategic plans calls for development of the right organizational structure, systems, culture, and the allocation of sufficient resources in the right places. Implementation of selected courses of action is a crucial step in the strategic management process. It is essential to involve, from the very beginning of the process, individuals and groups who will help to carry out the strategic plan.

Implementation also requires ongoing motivation. This means showing individuals and groups how their work has helped to achieve the organization's objectives. The plan must remain a highly visible driving force within the organization. Implementation of the plan must become an integral part of day-to-day operations. It is not something extra to do; it is the thing to do. As such, it is the impetus for motivation, recognition, and reward.

(vii) Performance Evaluation and Control

Performance evaluation and control is an important step needed to support the strategic plan. Performance evaluation is the comparison between actual results and desired results. Here performance evaluation involves obtaining information about strategic plans, performance and comparing the information with standard. This step keeps the planning and implementation phases of the management system on target by helping the organization, adjust strategies, resources, and timing, as circumstances warrant. In this step, a system is established to monitor how well the organization is using its resources, whether or not it is achieving desired results, and whether or not it is on schedule. Managers or executives at all levels use the resulting information to take corrective action and resolve problems. The monitoring and reporting system is continuous, with periodic output reviewed by teams, while major evaluations are conducted on an annual basis. A dual benefit of performance evaluation is that it subjects the strategic plan to discussion and testing in the context of the real world.

Although performance evaluation and control is the final major step in strategic management process, it can also pin point weakness in previously implemented strategic plans and thus stimulate the entire process to begin again.

 *For performance evaluation and control to be effective managers must obtain clear, prompt and unbiased information from people below them in company's hierarchy. Using this information, manager compare what is actually happening and what was originally planned in formulation stage. The evaluation and control of performance completes the strategic management process. Based on the performance results, management may need to make adjustment in strategy formulation, in implementation or in both.*

STRATEGIC MANAGEMENT IN GLOBAL BUSINESS SCENARIO

The 1990s witnessed dramatic changes in the dynamics of global and national market places. These changes produced variety of outcomes and still continue to shape the business landscape in the twenty first century. All these changes and the resultant outcomes brought strategic management at the core of the corporate

management irrespective of their location or scope of operation. The role of strategic management is to identify opportunities and threats in the external environment and use organizational strengths and weaknesses either to reap these opportunities or to meet the challenges. The rate of this change is accelerating day by day and so the tools and techniques of strategic management are increasingly being used to respond to these changes and inherent dynamics of external environment. A key to understand the role of strategic management is to have some perspective and understanding of the forces of this change.

The concept of global market place has taken on new meaning for all enterprises (small, medium and large) and for individual consumers. Changes in the government policies and the new technologies have made the global economy concept a fact of life.

 *Globalization coupled with liberalization and technological advancements have made the concept of national boundaries irrelevant from the business perspective because most of the products can be bought and sold any where in the world no matter how large or small the enterprise is.*

Presently every organization has to operate with a global perspective because either its operations have crossed the national boundaries or it is facing competition from global players in its domestic market. Now most businesses are not only buying and selling globally but using global alternatives and complex networks in their operations.

Globalisation has offered opportunities to gain new customers overseas, to achieve lower costs through overseas operations, and to achieve economies of scale. Global business can be undertaken through exports, licensing of products in favour of overseas partners, franchising functional subsidiaries, partly/wholly-owned subsidiaries, and joint ventures. Indian organizations are using all these avenues in varying proportion.

Strategies for global business differ from those for domestic business because of difference in the nature of competitive forces. A firm's decision to adopt strategies for global business depends on two factors:

(i) extent of cost pressures to denote the demand on a firm to minimize its per unit costs; and

(ii) extent of pressures for local responsiveness to denote to make a firm to tailor its strategies to respond to national-level differences in terms of variables like customer preferences and tastes, government policies, and business practices.

Often, these two factors are contradictory as minimizing costs may not be possible when products/services are to be differentiated. The juxtaposition of these two factors results in the following four types of strategies for global business:

(i) Global Strategy: In global strategy, assumptions are made that customer needs are similar worldwide. It is argued that markets are converging and increasingly people's needs and desires have homogenized. Therefore, firms can sell standardized products in the same way everywhere, for example, steel,

pharmaceuticals, cement, petroleum, etc. When given a choice between a low-priced standard product and a high-priced nationally customized product, many customers will go for low-priced product. Thus, firms offering standardized products globally have competitive advantage in the form of lower costs resulting from economies of scale in product development, production and marketing. In contrast, distinct markets mean incurring additional costs in most of value chain activities.

(ii) International Strategy: In the initial stages of globalization, a firm may not be in a position to opt for either global strategy or multidomestic strategy for its overseas business. They adopt international strategy which involves creating an international division and exporting the products through that division to those countries where the products are needed. At this stage of globalization, a company is really focused on the domestic market and just exporting what is demanded abroad. As the product becomes successful abroad, the company may set-up manufacturing and marketing facilities with certain degree of differentiation based on product customization. The key characteristic of this strategy is that all control is retained at the home office regarding product and marketing functions. Many multinational corporations have adopted this procedure.

(iii) Multidomestic Strategy: In multidomestic strategy, companies try to achieve a high level of local responsiveness by making their product/service offerings to the requirements of the countries they operate in. In this case, multidomestic companies attempt to extensively customize their products/services according to the local conditions operating in different countries. It is noted that some of the products may be standardized worldwide, but a majority of products cannot be. Customers' preferences and tastes are quite different in many countries for different products, for example, food products, garments etc. Similarly, differences exist in other areas too like infrastructure, distribution channels, government rules and regulations, etc. For meeting the requirements of all these conditions, customized products are needed. Hence, multidomestic strategy is essentially based on differentiation of the products.

(iv) Transnational Strategy: Transnational strategy involves adopting a combined approach of low costs and high local responsiveness simultaneously by the companies for their products/services. Integrating these two contradictory approaches is a difficult proposition and requires innovative ways.

RISKS IN GLOBAL BUSINESS

Global business has some additional risks besides the usual business risk which are of the following types:

(i) Political and Regulatory Risks: Many countries of the world are not politically stable and transfer of political power does not happen in smooth ways in these countries. Therefore, companies doing business in these countries may have risk in new political regimes. Similarly, many countries have different types of regulations for doing business. Such regulations may be of quite different nature as compared to those prevailing in the domestic country. Therefore, the regulations of the host countries should be taken into account.

(ii) Cultural and Managerial Risks: Countries differ widely in terms of cultural characteristics like customer preferences and tastes, attitudes towards certain types

of products/services, traditions, values and beliefs, and a host of other cultural factors. Therefore, products/services have to be tailored according to such requirements. Further, since management practices are culture-bound, the kinds of management practices which are effective in the domestic country may not be suitable in foreign countries. Therefore, there is a need for suitable change in management practices, more particularly related to human resource aspects.

REASONS FOR DOING BUSINESS GLOBALLY

Global business operations warrant competent, astute and aggressive strategic management in aspects-finance, production, personnel, but the key factors that determine its success or failure of business are market skills, acumen and know how. The reasons are as follows:

(i) Market Saturation: In case of advanced nation, market saturation is the immediate threat to the successful operation of the firms engaged in manufacturing unlike underdeveloped or developing countries where population grows faster than anything else-leave aside production of goods and services.

(ii) Foreign Competition: Facing intense competition is a common feature of all the under developed countries. Even in case of highly developed countries-their industries and industrial units are to face such a situation. The international competition improves quality, reduces costs and increases the consumer choice and satisfaction.

(iii) Trade Deficit: Trade deficit is a common feature of all under developed countries, through it is a rare phenomenon in case of developed nations. Though India is a fast developing nation, still it has threat of trade deficit. The negative balance is reduced and moving to positive balance by having business in the global sphere.

(iv) Foreign Programme: Both poor and rich countries cannot sustain in isolation for long period. Hence, the privileged are to help the less privileged and the least privileged. Thus, advanced countries have come out with foreign programmes on mutual exchange basis. Thus, USA granted billions of dollars to developing countries to undertake programmes of economic development under the condition that aid recipients to spend the money to purchase goods and services from American firms. This aid paved the way for not only trade but also saves the companies from a situation of closure due to inadequate demand for their product. This trade through aid is also applicable to India as it grants aid to less developed countries. This, indirectly generates global trade opportunities also.

(v) New Markets: For developed countries, the developing and the underdeveloped countries and in case of developing countries the less developed or under-developed countries constitute a major market for their products and services. The developed or developing nations have the contribution by these markets through international trade. The developed countries have higher growth rates creating an inevitable cycle of more employment, higher wages, urbanization, new life styles and the status symbols.

(vi) Business Adversities: Business is a game and is having the cycle of economic tide-waves of ups and downs. International business provides a safety net

or a cushion during business adversities. As one country depends on another, the bad economic health of one country is bound to influence the sound health of other dependent countries. This gives the golden opportunity to shift their trade emphasis from home to foreign markets.

(vii) Fiscal Concessions: Countries which are desirous of earning foreign exchange and creating employment opportunities to their nationals invite or attract foreign nationals to their countries by offering a package of special tax concessions. A company that wishes to take advantage will establish a plant in the low-tax country and sell the manufactured products in and outside that country. Thus, both the countries benefit by a joint-venture. In India, many multi-national companies have set-up their manufacturing/assembling bases and are operating in the field of pharmaceuticals, automobiles, information technology, etc.

(viii) Savings in Costs: Among the elements of costs, labour is very predominant, as much as it represents almost 50 per cent of the total cost. Profits can be easily increased where the labour costs are the minimum. That is why many advanced nations expanded their foreign operations in underdeveloped or developing countries where skilled labour is comparatively very cheap.

(ix) Utilise Full Capacity: A large and assured market is a must in industries where economies of scale are feasible. Many a times, the home market may not be able to absorb the entire output of an industry hence entry into foreign market hence becomes necessary. Thus, the need for fuller utilization of capacity makes the unit to go international.

(x) Avail Product Technology, Raw-Materials, etc.: A country that is exposed to global business conditions is geared to have increased access to advances in technology, world-wide raw-materials and diverse international economic groups. For instance, auto manufacturers led the way in fuel injection technology. Further, wider horizon makes available the inputs at cheaper costs. Even in the current patterns of economic blocks-or-trading blocks, it advantageous to go global.

(xi) Developing and Testing New Products: Many business firms prefer to develop and test their products in countries than in the home country. This is to avoid exposure to home competition and keep the development information as a secret till the product is taken up on commercial basis. The foreign markets provide the best opportunities of test marketing or target marketing.

ISSUES IN GLOBAL BUSINESS

Strategic management in respect of global business depends on the following aspects:

(i) Organisational Aspects

Resources can be allocated differently according to the treatment given to the organisation. A firm may establish a global financial system or it may treat foreign operations as a separate entity. In a unified system, excess cash in business units can be allocated by the management to the units that need money or to capital markets offering better returns. New capital can be available at the lowest cost. There are differences between countries in tax rates, freedom of remittances of

profits, associated risks and so on; it is found generally beneficial to take larger share of profit from business in one place than another. A unified system has the ability to manage the currency exchange rates more readily and easily. These abilities can be motivating force for the strategists to go global. A global company can organise its activities on a global basis. But there are certain forces such as economic, culture, etc. and varying national interests that operate against a unified organizational systems.

(ii) Resource Allocation

Global companies are to raise capital and allocate them to domestic and foreign operations to support their strategies. In earlier years, it was a simple process of transferring the funds from the parent company to establish operations in foreign countries. Now-a-days, resource allocation is more complex because the financial and technological resources are available from host countries and international capital markets. Entry into foreign markets through licensing, franchising, joint ventures and subsidiaries are the orders of the day. It has become a complex process.

(iii) Leadership

Leadership styles vary according to the nations and hence a company wants to have business relation. A leadership style calling for specific skills and techniques may not work all the time in the countries. A leadership style effective in U.S.A may not be effective in China.

(iv) Plans and Policies

An organisation system has an impact on plans and policies for implementing a strategy involving global activities, in the areas of financé, marketing, research and development, operations. In financial area, one has to face and manage fluctuating exchange rates, currency controls, quotas, tariff etc. Inflation, taxation and fiscal and monetary policies are influenced by the domestic and foreign government if the firm chooses to go global. Accounting principles and practices also vary from country to country. A unified financial system helps in easing these problems. In marketing area, the key issues is standardization of the product line across domestic and foreign markets. It relates product, prices, promotion and distribution variables. Research and development depends on how the firms take it. Countries are interested in bringing about faster economic process and welcome to build their own research calling for investment in this sector. A unified global research and development efforts allows spread of costs over a larger base as compared to research and development of national companies. However, responsiveness to local market conditions leads to the development of multiple research and development units. Production area, concerned with standardization to reduce costs and flexibility in management. An ideal strategy is one which is unified in which a limited number of factories of optimized scales of operation-choosing locations where material and labour costs are least. Instead of having entire production in one place, it pays to produce parts in one country and assemble in other parts.

STRATEGIC MANAGEMENT AND TECHNOLOGY

Technology can be viewed legitimately as a facilitator of change on a micro basis since it enables companies to frame strategies at micro level. However technology

can also be classified as a change driver on a macro basis. The revolution that has occurred in technology-hardware and software - has forced many companies to change the way they "do business". We live in an era that has been described by experts as the information age, where knowledge is power. Presently, experts businesses and consumers have much more information which not only influences how they buy and sell goods and services but also the *modus operandi* in the market place. Buyers no longer have to go to sellers place to view and buy products during business hours. The concept of time and place has assumed new meaning.

Technology is required to transform inputs into outputs which may be in the form of goods and services offered to customers. Technology management involves managing various activities involved in using a particular type of technology. It is a prime type source of developing competitive advantage as technology used is a significant factor in determining the degree of productivity in an organization. Technology is strategic in the sense that decisions regarding its choice are difficult and costly to reverse and have far reaching, long-term implications for a company.

Illustration:

Incorrect choice of technology for a product or process in a company could completely jeopardize its growth plans. The benefits that were expected to accrue on account of introduction of that product or process may never be realized.

Organizations can flourish or fail, depending upon their choice of technology. At the organization level, technology is an important strategic resource, like manpower, materials, finance, etc. and it ought to be managed as such. Effective management of technology has enabled many international organizations to make a niche for themselves in the world market through technological excellence. The strategic nature of technology, calls for the management of this resource as a part of overall business planning process to gain higher competitive advantage.

The combined impact of globalization, liberalization and technological advancement has resulted in dramatic power shift in the existing markets. In some industries, buyers have become more powerful because of changing demographics and increasing amount and quality of information available with the buyers. The demographics of our society, with the increase in two-career families and single parent households, have made "time" a critical dimension for many consumers. Increasing population of aged has made better customer service and ease to transact and operate as new value dimensions. The age old maxim "let the buyer beware" has changed to "let the seller beware". Today's consumers do not have the loyalty of previous periods or much patience with inferior quality in any area.

The consumers in today's marketplace are enlightened and empowered by the information that they have at their disposal from varied sources. Consumers have the opportunity to compare prices, quality and service. In turn, they demand competitive prices, high quality, tailored/customized products, convenience, flexibility and responsiveness. They tend to have a low tolerance level for poor quality in products and/or service.

The age old maxim has changed from “let the seller beware” to “let the buyer beware”:

True/False

False

The age old maxim has changed from “let the buyer beware” to “let the seller beware”



STRATEGIC MANAGEMENT IN KNOWLEDGE BASED ENVIRONMENT

The globalised competitive environment requires the firms to quickly respond to the customer's needs and problems for which they need enough knowledge and that is precisely what requires quality knowledge and strategic management.

Knowledge management



Knowledge management is a process which helps the enterprises to identify, select, arrange, extend and transfer important information and specialised knowledge.

In simple terms, its objective is to deliver relevant knowledge to relevant people at the right time. Knowledge management is based on the production, storage and use of knowledge. Knowledge categorisation and codification allows for successful and efficient problem solutions, dynamic learning, strategic planning and decision-making.

Thus, knowledge management is creation, distribution and utilization of knowledge at the individual, group, organizational and community levels through harnessing of people, process and technology for the benefits of those involved and affected by it.

A suitable organisation structure and modern information technologies can make use of knowledge in problem solutions regardless of place and time. The possibility of the exchange of knowledge between the organisation's members and a continuous extension of the knowledge basis is a fundamental pre-condition of the reasonable application of knowledge management on the way towards success.

The unique approach to the value resources has been one of the ways how to establish a sustainable competitive advantage. However, it is not always possible to secure such a unique opportunity, there are times when the competitors are able to imitate or replace such resources. But the enterprises that do have unique knowledge are usually able to combine and coordinate the use of their resources in a unique way which offers the customers higher value than that offered by the competitors.

In an enterprise just like in the economy as a whole, the physical and intellectual capitals are the generators of wealth and value. With respect to the external

environment changes and to the criteria changes, which measures the rate of success, the intellectual capital becomes the most important strategic resource. Intellectual capital consists of two parts — human capital and knowledge capital. Human capital includes individual skills and knowledge obtained through education, training, experience and learning. Knowledge capital includes documented knowledge available in a variety of forms — specialist articles, news, books, patents, software, etc. Another dividing line that can be drawn between the human and knowledge capital can be based upon the differentiation between the implicit and explicit knowledge: human capital includes predominantly implicit knowledge while knowledge capital includes explicit knowledge.

Knowledge is currently considered as the most important strategic resource, and the ability to create and apply knowledge has been a key factor in establishing a relatively sustainable competitive advantage. It has been naturally assumed that the enterprises that have better knowledge of their customers, products, technologies, markets and links between them, and that can apply such knowledge, can achieve better results. Such an opinion further develops a resource-based approach to the enterprise and pushes it towards the knowledge approach, which perceives an enterprise as a tool for creating, integrating, storing, sharing and application of knowledge.

Knowledge and learning are inseparable. Enterprise's knowledge base and its development can be supported through organisational learning. The ability to learn, to accumulate knowledge and experience and to re-apply them is alone a resource of a competitive advantage. The most valuable and the least imitable knowledge is implicit knowledge which is part of the work processes, collective spirit, of organisation culture. A knowledge-based enterprise, however, requires sharing the knowledge, i.e. its transformation into knowledge using the explicit form of articulation and codification. Such a requirement bears in itself an important paradox: the knowledge must be explicit so that it could be transmitted and shared within the enterprise. As soon as the knowledge becomes explicit the possibility of its transmission into other enterprises increases thereby decreasing its competitive value.

Human capital includes explicit knowledge while knowledge capital includes implicit knowledge?

No, Human capital includes predominantly implicit knowledge while knowledge capital includes explicit knowledge.



ELEMENTS OF KNOWLEDGE MANAGEMENT

The following are the elements of knowledge management:

(i) Creation of Knowledge: Creation of knowledge involves generating facts, information and techniques that are relevant to an organization and those associated with it. It discovers new knowledge through several avenues—research and development, experimentation, creation thinking and automated knowledge discovery, benchmarking best-in-class practices, process improvement projects, feedback from customers, observing customers, etc. Creation of knowledge is a

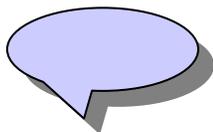
never-ending process; it keeps on accumulating changing and regenerating to suit to the circumstances. Individuals and groups can possess both explicit and tacit (implicit) knowledge. Explicit knowledge follows tacit knowledge in a natural way. While explicit knowledge that is embedded in organizational policies, procedures, routines, roles, etc. can be relatively harnessed through information technologies and other mechanisms, there is a challenge in tapping tacit knowledge because sometimes individuals who possess it are not aware about it.

(ii) Sharing of Knowledge: Sharing of knowledge involves communication and distribution of knowledge throughout the organization. When a new knowledge is created in the organization, it is stored in organization's database for its wider dissemination. The primary tools applied in knowledge sharing are information technology, process engineering and organizational dynamics. These enhance the flow of an organisation's knowledge to deliver it to individuals and groups for whom a given knowledge is relevant. Information technology makes it possible to capture, store and transfer knowledge from one point to another. With extensive use of internet and intranet, knowledge sharing has become easier even at the global level. Process engineering involves how organisational workforce works and how it learns. Personnel rotation, education and training programmes, standardization of programmes and site visits are good methods for knowledge sharing. Organisational dynamics shows the pattern of personal interaction through which knowledge can be shared.

(iii) Utilisation of Knowledge: Knowledge utilization is using knowledge to solve problem for which it has been acquired. Unlike other resources that deplete when used, knowledge can be shared and used and grows through this process. Knowledge perishes when it is not used but it increases when it is used. It is essentially self-regenerative such that the identification of a new knowledge immediately creates demand for the production of subsequent information.

IMPORTANCE OF KNOWLEDGE MANAGEMENT

The need to focus on managing knowledge within the enterprise results from the following:



- (i) Economic and market-driven requirements created by customer demands and international competition.*
- (ii) Increase in customer demands for products and services that fulfill their particular needs more precisely and to a greater advantage.*
- (iii) Loss of knowledge to the organisation due to increased personnel turnover.*
- (iv) Helps organisations to be able to repeat the processes followed in past successful projects.*
- (v) Effective knowledge management practices helps the organisations to avoid repeating mistakes of past projects, thereby reducing the time span required for completing current projects.*

IMPLEMENTATION OF KNOWLEDGE MANAGEMENT PROGRAMME

Knowledge Management programme may be implemented in the following ways:

(1) Defining Knowledge Management Strategy

Knowledge management strategy is defined in advance so that a systematic approach is followed. It requires the active involvement of top management so that its commitment and support are ensured. Knowledge management strategy contains the following:

- **What to Share:** Different aspects of technical know-how, managerial know-how, competitive intelligence, operational processes, etc. can be shared. Sharing of all these has its cost and benefit. The issues related to quality and authentication of what is being shared should also be addressed.
- **Why to Share:** Knowledge for the sake of knowledge has no relevance rather it must be used for organizational betterment. Knowledge management strategy should specify the way in which the organisation will be benefited through practicing knowledge management. In this globalised economy, knowledge management enhances organizational position through enhancing creativity and innovation, providing perception of opportunities, increasing speed and quality for product delivery, lowering operation cost by avoiding repeating the work, and enhancing satisfaction level of employees and employers.
- **How to Share:** In this stage the decision about mechanism of knowledge sharing is made. There may be different channels for sharing knowledge such as personal face-to-face contact, deputing personnel to the sharing parties, computer networks—internally and externally, etc. depending on the nature of parties, and the channel chosen.
- **Whom to Share:** There are different types of people and organizations with whom knowledge can be shared. They are internal employees at various levels, customers and suppliers, shareholders and financiers, research organizations, collaborators, etc. Choosing of persons with whom knowledge is to be shared should be decided in the light of why and what to share.

(2) Organizing Knowledge Management Programme

For organizing knowledge management programme, a knowledge management centre should be established. Besides this, the business should undertake the following steps to implement the knowledge management programme:

- **Providing Budget for Sharing Knowledge:** Knowledge management programme involves cost in the form of outlay on physical facilities, information technology, personnel involved, etc. Therefore, a budget should be prepared in advance for launching the knowledge management programme.

- **Communicating the Value of Sharing Knowledge:** Before the knowledge is shared among various constituents, it is essential that they are informed about the value of knowledge sharing, how it will be useful to them and to the organization and what processes can be adopted for knowledge sharing.
- **Choosing Technology for Sharing Knowledge:** Knowledge can be shared by using a channel which is provided by the technology chosen for this purpose. Information technology consisting of computer hardware, computer software, database and telecommunications etc. is suitable for knowledge sharing throughout the organization and its various constituents.
- **Selecting Methods of Sharing Knowledge:** Knowledge in an organisation can be shared in the following forms:
 - (a) *Serial Transfer:* This happens when a firm that performs a task repeats it in a new context.
 - (b) *Near Transfer:* This takes place when knowledge is moved from a source team to a receiving team doing a similar task but at a different location.
 - (c) *Far Transfer:* This happens when tacit knowledge about a non-routine task is moved from a source team to a receiving team.
 - (d) *Strategic Transfer:* This takes place when very complex knowledge is moved from one team to another specially when both the teams are separated by time and distance.
 - (e) *Expert Transfer:* It takes place when tacit knowledge about a task that is not done very frequently is moved from one team to another team.
- **Measuring of Performance:** When knowledge-sharing methods are put into practice, their impact should be measured continuously to ascertain whether they are effective in knowledge sharing. If yes, these methods can be applied repeatedly; if not, suitable corrective actions should be taken to bring them on desired level.

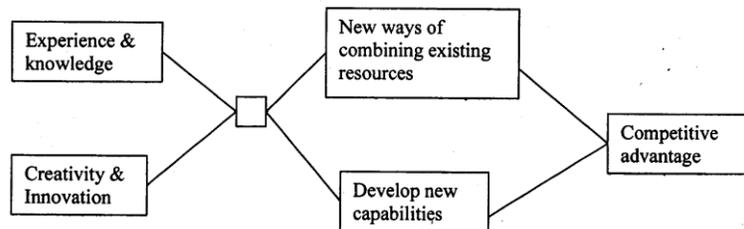
(3) Reinforcement for Knowledge Management

Reinforcement for knowledge management is necessary to make it a part of organizational processes and practices. It increases the strength of a new behaviour and tends to induce repetition of that behaviour. Reinforcement should be provided so long as knowledge sharing does not get imbibed into personnel. In order to provide reinforcement for knowledge management, the business has to:

- **Introduce New Incentives:** Incentives are those objects that are perceived by people as being important to satisfy their needs, which may be in financial or non-financial forms, and
- **Provide Support Knowledge Sharing:** The business should provide support to employees for sharing knowledge. This facilitates knowledge sharing and employees feel that top management has given attention to them.

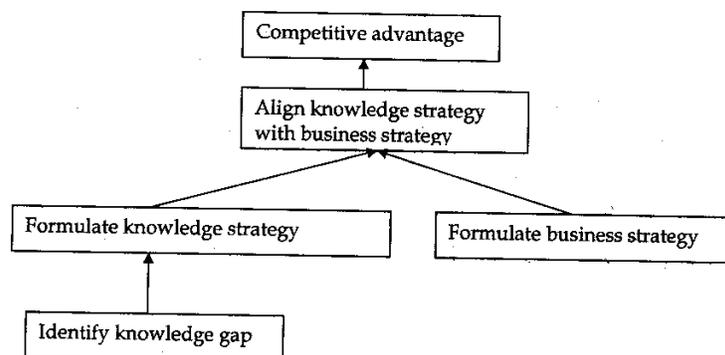
INNOVATION AND KNOWLEDGE STRATEGY

Innovation and creativity play a very important role in designing and driving the business strategy of any present day organisation. In the present industry scenario, an organisation does not enjoy sustainable competitive advantage, merely by possessing resources and capabilities. They should be able to combine these resources in new and different ways or develop new capabilities to gain sustainable competitive advantage. This is possible through creative thinking and innovation. This case be explained by the following diagram:



Some of the innovations brought out by organizations are a result of application of new knowledge and the others are a result of working with the recasting existing knowledge, termed as 'architectural innovation'. The following diagram shows an approach to competitive advantage:

Approach to Competitive Advantage



Organizations pursue different strategies to align their knowledge management strategies with the business strategies. Some of these strategies can be framed as under:

Strategy	Focus
Codification strategy	Automation and application of IT
Personalisation strategy	Building a learning strategy
Strategic management of intellectual capital	Building, managing and exploiting knowledge-related assets.
Enterprise effectiveness strategy	Applying all the available knowledge in the best interest of the firm.

In the current industry scenario of flux and uncertainty, organizations cannot achieve sustainable competitive advantage, by pursuing just a product-market based strategy or a resource based strategy. They need to appreciate the importance of the knowledge existing in the organization and harness the knowledge through appropriate knowledge management strategies and align this strategy. Moreover, they also need to create new knowledge through creative methods and build new capabilities to achieve sustainable competitive advantage.

It shows that present global and knowledge based environment has a great impact on the market and industry structures. It has also changed the nature of competition in the market and competitive advantage possessed by the companies. Strategic management with its tool and techniques is increasingly being used to meet the challenges and exploit the opportunities of modern, complex highly competitive and knowledge based globalized economies.

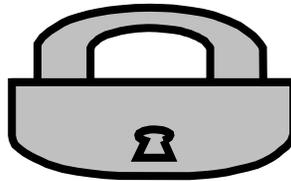
LESSON ROUND UP



- Firms use strategic management process to achieve strategic competitiveness and above average returns.
- A strategy is a plan or course of action which moves an organization from its current position to a desired future state.
- Role of strategic management is increasing day-by-day because of the increasing complexity and dynamism of the environment.
- Strategic management process involves following stages:
 - setting organizational mission and developing objectives
 - environmental analysis,
 - organizational assessment,
 - identifying strategic alternatives,
 - choice of appropriate strategy,
 - implementation of strategy, and
 - performance evaluation and control.
- In any firm strategies may be at different levels i.e. corporate-level, business-level and functional-level.
- Globalisation has offered opportunities to gain new customers overseas.
- Global business can be undertaken through exports, licensing of products in favour of overseas partners, franchising functional subsidiaries, partly/wholly-owned subsidiaries, and joint ventures.

- Technology management is a prime type source of developing competitive advantage as technology used is a significant factor in determining the degree of productivity in an organization. Technology is strategic in the sense that decisions regarding its choice are difficult and costly to reverse and have far reaching, long-term implications for a company.
- Knowledge management is a process which helps the enterprises to identify, select, arrange, extend and transfer important information and specialist knowledge.
- Strategic management by its very nature is creative and innovative. Firms generally adopt strategic management in different phases. Sometimes it is adopted deliberately and sometimes because of outside pressure.

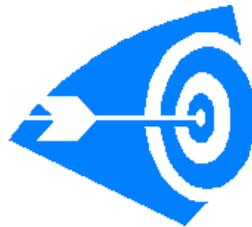
SELF TEST QUESTIONS



1. "A strategy is a unified comprehensive and integrated plan that relates the strategic advantages of the firm to the challenges of the environment" Explain.
 2. Define strategic management and list out its benefits and limitations.
 3. Discuss the role of strategic management in the success of modern organizations.
 4. Explain the various phases of strategic management process. Do you think that various phases of the process are interacting?
 5. Explain the levels at which strategy operates. What are the characteristics of decisions at different levels of strategy?
 6. "Even though strategic management focuses on top level decisions, yet the knowledge of the subject would be practical and useful for early career stages of a manager." Explain how.
 7. Discuss various processes of strategic management.
 8. "Strategic management has both general and specific role in management." Comment.
 9. What do you mean by global business? State the reasons that prompt the companies for doing business globally.
 10. What are the issues in knowledge management? Discuss the way in which a knowledge management programme can be implemented.
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STUDY II
**ENVIRONMENTAL SCANNING AND INTERNAL
APPRAISAL ANALYSIS**

LEARNING OBJECTIVES



The object of this study lesson is to enable students to:

- Understand the implications of environmental analysis in an organization
- Classify the various environmental factors in the organization
- Analyse the general economic conditions and market factors
- Comprehend the meaning and techniques of forecasting
- Explain the Porter's five forces model of industry analysis
- Enumerate the two stages of internal analysis i.e. financial and functional analysis
- Identify the major areas of functional analysis
- Explain the tools and techniques of strategic management
- Understand the concept of SWOT analysis
- Make use of situational analysis
- Explain the meaning of PEST analysis
- Understand the process of Gap analysis
- Identifying impact analysis
- Explain the concept of value chain and its implications for strategic management
- Understand the meaning of business process re-engineering and its steps and principles.

INTRODUCTION

A strategist is required to understand all the intricacies of external environment in which an organization operates as well as the internal operations of an organization before a strategy can be effectively formulated and implemented.

An organization's environment consists of two parts:

- (i) the macro environmental dimensions i.e. economic, technological, legal, political, socio-cultural and, global; and
- (ii) the micro environment which refers mainly to the industry within which it operates (for multi-business firms, the industry is usually considered in the

activity in which the firm generates the majority of its revenue). So, for the purpose of strategic management first a strategist has to analyze these macro environmental dimensions and then a detailed analysis of the industry needs to be done.

Environment analysis requires two activities:

- (a) information gathering, and
- (b) evaluation.

Environmental scanning analysis and internal appraisal are the important aspects of strategic management for effective decision-making in situations of uncertainty with a view to attain desirable objectives of the organization by making optimal use of human and material resources.

Environmental scanning analysis is basically concerned with identification and analysis of environmental influences individually and collectively to determine their potential. This analysis consists of tracing the sources of any opportunity or threat to break the whole into parts so as to examine its nature and its inter-relationship. It is from such analysis that management can make decisions on whether to react to, ignore or try to influence or anticipate future opportunities or threats discovered. Thus, it is a holistic exercise which includes a view of environment i.e., 360 degree coverage. It must scan the whole circumstance of its environment in order to minimize the chance of its surprises and maximize its utility as an early warning system.



Environmental scanning analysis is concerned with identification and analysis of environmental influences individually and collectively to determine their potential. It is a holistic exercise which includes a view of environment i.e., 360 degree coverage.

The four analytical activities i.e. environmental analysis, industry analysis, internal financial analysis and internal diagnosis of functional areas—are undertaken to generate a data set consisting of strengths, weaknesses, threats, and opportunities that comprehensively describes the internal and external characteristics of the organization. This information is then used as input to the strategy formulation process. It is factored with data about past strategies, vision, mission, goals, objectives, corporate culture, managers' values, and so on to evaluate the success or failure and strengths and weaknesses of present strategies. As a result present strategies can be modified, left as they are, or replaced as necessary in a particular situation.

By its nature strategic management requires contextual thinking—the recognition that all organizational activities, whether planned or not, occur under sets of very specific and real circumstances. These circumstances or contexts often change dramatically over time, and differ substantially from firm to firm, industry to industry, and market to market. The key to effective strategic management is to make major managerial decisions that shape actions by the firm that will correspond positively with the context within which those actions ultimately take place.

Environmental conditions affect the entire strategic management process. Management's perceptions of present and future operating environments and internal strengths and weaknesses provide inputs to goal and action plan choices. They can also affect the manner in which implementation and internal circumstances will dictate the effectiveness of strategies as they are implemented. The implementation stage of strategic management provides the real, as opposed to the expected, interface between the firm and its environment.

Internal appraisal analysis or corporate analysis is concerned with the process of reviewing the organization resources, scanning organizational activities and identifying the strength and capabilities. Thus, it involves an attempt to assess the nature and magnitude of resources reflecting the inherent strength of the resource base comprising physical, financial, human as well as intangible resources of a firm.

In the internal appraisal analysis, financial analysis—the technique of learning about the financial performance of the firm or organization is addressed. Very often financial analysis will bring to light several financial strengths and weaknesses that are indicative of strategic or operating capabilities and problems within the various strategy levels and within functional areas. Financial analysis is typically followed by internal diagnosis of functional areas. This technique identifies strengths and weaknesses within such areas as marketing, personnel, finance, research and development, and others.

The effects of the environment on the organization, as well as the success of its present strategies, are ultimately reflected in its financial statements. A large part of the task of internal diagnosis is accomplished by financial analysis. Of course, there is more to analyzing the internal operations of a business than financial analysis. By understanding the theory and practice of management, marketing, accounting, personnel, production, and other functional aspects of organizational performance, internal strengths and weaknesses can be found beyond by the financial analysis. But financial analysis uncovers clues to functional strengths and weaknesses.

Both environmental and industry analysis procedures consist of the following interrelated processes:

- (i) Developing assessment taxonomy to outline major environmental dimensions.
- (ii) Defining environmental boundaries.
- (iii) Monitoring and forecasting changes in key variables.
- (iv) Assessing potential impacts on the firm or industry in terms of whether they are threats or opportunities.

INFORMAL AND FORMAL SCANNING

Sensing the pulse of environmental threats and opportunities is a natural and continuous component of business planning process. In many organizations, it is done on an informal basis. An executive in a construction company who learns from an official of the Government in a social get-together about a request for bids on a major construction project is gaining information that could affect the performance of

his firm—information that would be as valuable as it would have been acquired through more systematic means. Discovering changes in tax statutes by perusing the economic dailies or business journals is no less important than learning about them through a well-established monitoring system within the firm's legal or accounting office. Indeed, acquiring valuable information through informal means often marks the success of an entrepreneur and manager.

However, totally relying on informal means increasingly exposes the firm to missed opportunities and unforeseen threats. A missed social get-together or an overlooked column in the economic or financial dailies can have profound implications, even if the implications themselves go unnoticed. Therefore, a systematic approach to environmental assessment is important for the management of uncertainty and risk.

Survey can be used as formal approach for generating data about environmental conditions. The use of both original and contracted survey research for purposes of evaluating the present corporate environment offers a lot of promise for strategists. Analysis of external concerns in the survey research is a way to accurately identify the attitudes of selected population groups towards the company. In fact, any external constituency's attitudes towards the organization can be assessed through survey research methods.

ENVIRONMENTAL ANALYSIS

The dimensions of environment can be generally classified by a set of key factors that describe the economic, technological, legal, political, socio-cultural and, global surroundings. These, in turn, can be overlaid by the various constituents of the firm, including shareholders, customers, competitors, suppliers, employees, and the general public.

The managers should identify their relevant environment so that they can analyze the various elements in order to relate their organization with the respective environment. Since the orientation towards relevant environmental factors differs from organization to organization, there may be lack of unanimity on such factors.

Illustration:

Duncan has classified the relevant components of environment for an organisation into five categories: consumer component, supplier component, competitor component, socio-political component and technological component. On the other hand, Glueck has grouped the environmental factors into six broad categories: economic, government-legal, market competitive, supplier, technological and geographic and social. D .R. Singh, while analyzing environmental issues taken up by multinationals, has emphasized the following factors: economic situation, political situation, and financial situation. He has further classified the political situation into industrial development policy, foreign investment policy, corporate taxation policy, import-export policy, industrial licensing, foreign exchange control, and capital issue control.

These classifications suggest that the environmental factors may be classified in

various ways. However, the classification of these factors must be in such a way that it presents some framework by which to view the total situation with which the managers confront. This provides managers a sharp focus on the relevant factors of the environment. They make decisions in the light of the various environmental forces as perceived by them. This requires the classification of environmental forces which distinguishes each element from others so that managers can pinpoint the impact of each on their organizations. However, it can be emphasized here that environmental factors are intertwined; they affect each other and are affected by others.

For example, the economic factors of a country are likely to be affected by the political and legal aspects of the country. In the same way, economic aspects may determine technological factor but is affected by the latter.

An analytical classification of various environmental factors are as follows:

- Economic environment,
- Technological environment,
- Political-legal environment,
- Socio-cultural environment, and
- Global environment.

ECONOMIC ENVIRONMENT

Economic environment is by far the most important environmental factor which the business organizations take into account because a business organisation is an economic unit of operation. Since the measurement of organizational performance is mostly in the form of financial terms, often managers concentrate more on economic factors. The economic environment is important for non-business organizations too because such organizations depend on the environment for their resource procurement which is greatly determined by the economic factors. As such, the understanding of economic environment is of crucial importance to strategic management. Economic environment covers all those factors, which give shape and form to the development of economic activities and may include factors like nature of economic system, general economic conditions, various economic policies, and various production factors.

From the analytical point of view, various economic factors can be divided into two broad categories: general economic conditions and factor market. The discussion of these factors will bring out the nature of total economic environment.

General Economic Conditions

General economic conditions of a country determine the extent to which various economic forces influences an organization. Such forces include: economic system, monetary policy, fiscal policy and industrial policy of the country. However, the general economic conditions are also affected by the political and social factors. These economic conditions affect national income, distribution of income, level of employment, factor market and product market. In turn, all these factors taken

together affect the working of business organizations. An intensive analysis of these forces will give a picture of the conditions in which the organizations have to operate.

(a) Economic System: An economic system refers to a particular set of social institutions which deals with production, distribution and consumption of goods and services in a particular society. It is basically composed of people and institutions, including their relationship to productive resources.

The economic system of a country determines the extent to which the organizations have to face different constraints and controls by the economic factors. In three alternative economic systems, i.e. capitalistic, mixed, and socialistic, organizations have to face different types of control ranging from total freedom to total control. An economic system not only puts certain restrictions over the functioning of the organization but also provides certain protections to an organisation depending on its nature. For example, public sector organizations are protected from private organizations, local organizations from foreign organizations, small organizations from large organizations, and so on. India has adopted the mixed economic system.

(b) National Income and its Distribution: National income is defined as the money value of final goods and services produced in a country during a particular period of time normally one year. National income determines the purchasing power of people and consequently generate the demand for products. Distribution of national income determines the types of products that may be demanded by different segment of people. Per capita income determines the purchasing power.

(c) Monetary Policy: Monetary policy controlled by a Central Bank of a country regulates the economic growth through the expansion or contraction of money supply in circulation. There are three basic objectives of Indian monetary policy:

- To provide necessary finance to the industries, particularly in private sector;
- To control the inflationary pressure in the economy; and
- To generate and maintain high employment.

(d) Fiscal Policy: Fiscal policy deals with the tax structure and governmental expenditure. Generally the fiscal policy is adopted for:

- Mobilizing maximum possible resources;
- Optimal allocation of resources so as to attain rapid economic growth;
- Attainment of greater equality in the distribution of income; and
- Maintenance of reasonably possible stability of prices.

There are two aspects of fiscal policy relevant to strategic management: (i) the impact of the tax structure on the fortunes of individual organizations as well as the industry; and (ii) the impact of government's spending on different economic activities.

A policy/system that deals with the tax structure and governmental expenditure is called:

- (a) Monetary Policy**
 - (b) Fiscal Policy**
 - (c) Economic System**
- (b) Fiscal Policy*



Organizations employ different factor inputs in the process of production such as land, labour, capital, managerial personnel, etc. The management should appraise the availability of these factors inputs so that suitable strategies can be adopted for their procurement and utilization. The easy availability of these resources facilitates the organizational functioning. In addition to availability, cost and quantity of resources are significant. While analyzing the factor market aspect of economic environment, following considerations should be taken into account.

(a) Natural Resources: The availability of natural resources i.e. land, minerals, fuel, etc., becomes a strategic planning factor for organizations requiring such resources in the production process. Normally, location pattern is decided on the basis of availability of these factors. In our country, there are plenty of natural resources-land, water and minerals of various types. However, in the absence of their proper exploitation and uses, these resources are not able to give adequate benefits. Moreover, there is lack of certain critical factors, for example, electricity, fuel, etc., which affect the organizational efficiency adversely.

(b) Infrastructure Facilities: Infrastructure provides the supporting base for the efficient functioning of an organization in the industry. These may include transportation, communication, banking services, financial services, insurance, and so on. In our country, while these facilities are available in plenty and at satisfactory level at some places, there is total absence or inadequacy at some other places. For example, in urban areas, these facilities are available to a reasonably satisfactory level but these are lacking in rural areas where the scope for opening more business operations is quite high. The government is emphasizing the development of backward areas by giving various incentives to the organizations and through creating the provisions for infrastructure.

(c) Raw Materials and Supplies: An organization requires continuous flow of raw materials and other things to maintain its operations. The price of materials, frequency and regularity of supply and other terms and conditions are important considerations in this respect. All these factors, in turn depend on the availability of natural resources, infrastructure facilities and general economic development of the country.

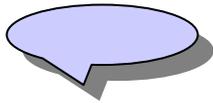
(d) Plant and Equipment: An organisation invests money in plant and equipment because it expects a positive rate of return over it's investment in future. The revenue from the use of the plant and equipment should be sufficient so as to cover the invested money, operating costs, and generate enough profits to satisfy the

organisation. Greater uncertainty in these would make the cost of plant and equipment a more important strategic factor. The availability of plant and equipment is dependent on the technical development of the country and the government's approach towards foreign technical collaboration.

(e) **Financial Facilities:** Financial facilities are required to start and operate the organisation. The external sources of finance are share capital, banking and other financial institutions, and unorganized capital markets. The recent changes in the Indian capital market indicate the availability of plenty of finance both from the financial institutions as well as from general public. In fact, the organisation and working of Indian capital market can be compared favorably with many industrially advanced countries. The availability of finance coupled with various incentives attached, is a facilitating factor. However, such facilities have been utilized by only some large scale and medium scale organizations.

(f) **Manpower and Productivity:** While the availability of factors of production affects the development of the country as well as individual organizations, the level of productivity affects the organizational efficiency and profitability. The productivity of both human and physical factors is dependent on many factors, such as, the type of technology used, the production process applied, the organizational processes, and the use of managerial techniques etc.

While analyzing the economic environment, the organization intending to enter a particular business sector may consider the following aspects:



1. The economic system to enter the business sector.
2. *The stage of economic growth and the pace of growth.*
3. *The level of national and per capita income.*
4. *The incidents of taxes, both direct and indirect.*
5. *The infrastructure facilities available and the difficulties thereof.*
6. *Availability of raw materials and components and the cost thereof.*
7. *The sources of financial resources and their costs.*
8. *Availability of manpower-managerial, technical and workers available and their wage structures.*

TECHNOLOGICAL ENVIRONMENT

Technological environment refers to the sum total of knowledge providing ways to do things. It may include inventions and techniques, which affect the ways of doing things, i.e., designing, producing, and distributing products. Technological environment is important for business as it affects the type of conversion process that it may adopt for its purpose. A given technology affects an organisation in the way it is organised and faces competition. From the strategic management point of

view, technology has following implications:

- (i) Technology is a major source of increasing the productivity. Though human beings are primarily responsible for handling technology, their efficiency is determined by the type of technology used.
- (ii) Various jobs in an organisation performed by individuals are determined by the technology used. If there is a change in technology, the nature of jobs are changed because technology determines the level of skills required.
- (iii) Technology influences the social situation. The size of groups, membership of groups, patterns of interpersonal interactions, opportunity to control the activities etc., are influenced by technology in a variety of ways.
- (iv) Organizations become secured by developing efficiency through the adoption of latest and efficient technology. Since the technology has become more complex, it is difficult for new organizations to enter the field.
- (v) Technology influences the cost of production and quality of the product/service.
- (vi) There is a time gap in employing new technologies both within an organisation and among organizations in a field. Time gap within the organisation means that adjustment to technological innovation will be spread over a number of years. Within the industry, if a new technology is adopted by an organisation, others in the same industry will follow the same, but because of time gap, the first organisation will have some edge over others.

The major strategic implications of technological environment are as follows:

- (i) It can change relative competitive cost position within an organization;
- (ii) It can create new markets with new business segments; and
- (iii) It can merge with independent businesses by reducing or eliminating their segment cost barriers.

The technological environment of the country is subject to change because of import of technology and research and development within the country. Indian Government is quite liberal in regard to the import of appropriate technology from foreign countries to enhance efficiency and to make the industry competitive internationally. It is also encouraging the development of internal technology by providing various incentives to the business organizations concerned as well as through other technical institutions.

Thus, in analyzing the technological environment, the organisation may consider the following aspects:

1. The level of technological development in the country as a whole and specific business sectors.
2. The pace of technological changes and technological obsolescence.
3. The sources of technology.

4. The restrictions and facilities for technology transfer and time taken for absorption of technology.

POLITICAL – LEGAL ENVIRONMENT

Political-legal environment consists of laws and regulatory framework and political set-up in which a business unit is operating. The stable political set-up and legal framework in the economy influence the decisions of the organisation. S.H. Robock has developed a conceptual framework for identifying and assessing political risk which may affect business decisions. The major sources of such risks include competing ideologies, vested interest in local business groups, electoral majority of the party in power, dissension in the ruling party, insurgencies in border areas, international power alignment and alliances, foreign economic policies of the government abroad, national and regional interest etc.

Political-legal environment factor is particularly important in a mixed economy like India, and it has significant effect in working of business organizations. Legislature, judiciary and executive are three major organs of political and legal environment. Political-legal environment includes the following elements:

1. Political system i.e. political processes, political organizations-political parties, political stability, extent of bureaucratic delays, etc.
2. Legal rules of the business-their formulation, implementation, efficiency, and effectiveness.
3. Defence and foreign policies—defence expenditure, maintenance of external relationships with other countries, etc.

Political-legal environment can be divided into the following two parts:

1. Promoting environment; and
2. Regulatory environment.

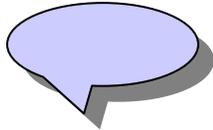
Promoting Environment: Promoting environment includes the stimulation of business interest through the provisions of various incentives and facilities, thus protecting home products and markets from the influence of foreign competitors, taking direct role of promoting business insurance. In India, Government offers all these facilities in the form of sound infrastructure—transport, electricity, banking and postal and telecommunication, promoting business abroad, promoting business in public and joint sectors; concessions and benefits to various types for industries located in specified areas.

Regulatory Environment: Regulatory environment puts certain restrictions on the operations of business organizations. These restrictions are not of arbitrary nature but are based on the nature of a social system and are the effective means or the instruments of achieving the desirable level of social welfare in the country. In India, the regulatory environment consists of the factors related to the regulation of business operations by prescribing their freedom to operate in certain areas of business and the practices that are required to follow in conducting their business. These have been stipulated by legislative measures in the form of various statute and policy formulation. For example important regulations are enforced in India which

influences the functioning of business organization, includes the following:

- (a) Industrial policies and licensing,
- (b) Competition Law,
- (c) Foreign Exchange Management,
- (d) Import and export regulation,
- (e) Foreign operations, collaboration, and joint ventures,
- (f) Protection of consumer interest,
- (g) Prevention of environmental pollution,
- (h) The Companies Act and other Economic Legislations.

Thus, in analyzing political-legal environment, an organisation may broadly consider the following aspects:



- *Influence political system of the business;*
- *Approaches of the Government towards business i.e., restrictive or facilitating;*
- *Facilities and incentives offered by the Government;*
- *Legal restrictions such as licensing requirement, reservation to a specific sector like public sector, private or small-scale sector;*
- *Restrictions in importing technical know-how, capital goods and raw materials;*
- *Restrictions in exporting products and services;*
- *Restrictions on pricing and distribution of goods;*
- *Procedural formalities required in setting the business;*
- *Economic and Financial Sector Reforms.*

SOCIO-CULTURAL ENVIRONMENT

Social-cultural environment is another important aspect of environmental scanning in strategic management. It basically refers to the set of values, ideals, attitudes, belief, desires, expectations which distinguish one group from those of another. The organisation needs to be aware of how social and cultural factors can directly influence the way they manage their operations particularly human resources and marketing. The executives in the organization need to be aware of sensitive values and ideas of people coming from different up-bringing and backgrounds. Changes in aspirations, habits, customs and values lead to generation of new opportunities and threats to the business organization.

Broadly speaking, the socio-cultural environment covers the following:

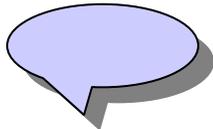
- (i) Expectations of the society from the business;
- (ii) Attitudes of society towards business and its management;

- (iii) Views towards achievement of work;
- (iv) Views towards authority structure, responsibility and organizational positions;
- (v) Views towards customs, traditions, and conventions etc.;
- (vi) Labour mobility and level of education.

The elements of social and cultural environment affect the working of the organizations mainly through organizational objective setting, organizational processes and the products to be offered by the organisation. These aspects affect the total functioning of the organisation. The social and cultural factors affect the basic objectives of the organization by specifying the norms within which the organizational objectives are formulated. Organizational processes are also designed keeping in view the various social and cultural factors. Since the organization works as mediator for converting inputs into outputs, and these outputs are given to the society, it can produce only those things, which are accepted by the society. Hence, social and cultural factors affect the goods and services that can be offered by the organisation.

Sometimes, managers while formulating or implementing their strategies do not consider the social and cultural factors adequately. The result is failure of strategies and loss to organization in terms of loss of opportunities and additional cost. In global dynamic competitive environment the social and cultural factors are also subject to change. This change is gradual and steady which can be forecasted with comparative ease once the managers get an insight of these factors.

In analyzing social and cultural factors, the organisation has to see the following aspects:



- *Approaches of the society towards business in general and in specific areas;*
- *Influence of social, cultural and religious factors on acceptability of the product;*
- *Life style of people and the products useful for them;*
- *Level of acceptance of, or resistance to change;*
- *Values attached to a particular product i.e. possessive value or functional value in the product;*
- *Demand of specific products for specific occasions;*
- *The propensity to consume and to save.*

GLOBAL ENVIRONMENT

Business organization in every industry is facing the rising tide of globalization.

The world has reduced to smaller place as a result of revolution of means of transport and communication and diffusion in information technology. So today, business organization needs to think about setting and producing goods for customers globally. Globalization basically presents existing opportunities and challenges to many companies.

In this era of globalization, many multinationals derive more than half of their revenues from their overseas operations.

Illustration:

Many Indian companies particularly in information technology sector such as Infosys Technologies, Tata Consultancy Services, Wipro, Satyam Computers, Hughes Software, etc., drive more than 70 percent of their revenues from overseas operations.

Globalization is thus changing the rules of games in business. On the one hand, it has created new opportunities for Indian industry. On the other, Indian firms are facing increasing competition. Therefore, there is a need for scanning global environment. From strategic management point of view, the analysis is required to open operations abroad and to understand the implications of entry of multinational corporations in the country and the freedom of importing products and services from abroad.

In the case of analyzing global environment in the context of threats through import and operations of multinational corporations in the country, the following factors are to be considered:

1. Comparative cost advantages through technological advancement and large scale production.
2. Tariff structure.
3. Attitudes of exporting nations and companies in the form of dumping and other means to take advantages over local companies.
4. Degree of subsidies and incentives, financial and non-financial, available to exporting companies.
5. Attitude of the customers abroad.

These factors have become more crucial and relevant in the liberalized Indian economy because it has opened its markets to MNCs almost in every sector and that too in unrestricted form. Therefore, Indian companies have to be very cautious in their approach.

FORECASTING

Future is unknown and uncertain. So there is the need to translate environmental observations into forecasts of the environment within which future goal and action plan formulation and implementation will take place. We forecast or predict environmental conditions in the context of opportunities and threats for the purpose

of establishing a set of strategic data. This data becomes the basis for goal and action plan decisions. The general direction of change is addressed within the confines of anticipated limits.

In many cases the environmental forecaster needs to make multiple forecasts so that contingency goals and action plans can be developed. For example, a single-point forecast of interest rates for one year may be a dangerous premise upon which to base an expansion strategy. Instead a well-designed multiple forecasts of interest rates can lead to contingency expansion strategies.

Forecasts can be made in the context of reasonable ranges. Here the analyst is less concerned with anticipation of precisely what the future will bring than with the likely future nature of environmental conditions. This is especially useful when the forecasting horizon is more distant. The general direction of change is addressed within the confines of anticipated limits.

FORECASTING TECHNIQUES

There are several methods which can be used to forecast different environmental variables in future. Some of the popular techniques used by business strategists are discussed as under:

- (i) ***Trend Extrapolation Technique:*** This involves picking a tracking factor or environmental variable, noting its trend (statistically or otherwise), and extending that trend into the future. Lead and lag correlates are often used in the process. Linear and non-linear statistical models and techniques can be used when hard numerical data exist. This normally involves line fitting to historical data, and extending the line into future periods. Most spreadsheet programs and some operating systems have easy-to-use trend line extrapolation routines built into them. Of course, more sophisticated packages like SPSS (Statistical Package for the Social Sciences) and SAS (Statistical Analysis Software) are also available, which allow detailed trend line analysis. The validity and reliability of this technique must be carefully evaluated in each application. Parameters must be appropriately selected and intrinsic or environmental constraints be also identified.
- (ii) ***Historical Analogy Technique:*** It involves identification of precursor or concurrent events and simple recognition of the relationship. Under this technique a forecaster really examines a series of analogous (though not identical) events. Because forecasting by analogy is used where historical data are inadequate for the more formal trend extrapolation, its validity and reliability are open to challenge.
- (iii) ***Delphi Techniques:*** Under this technique, the divergent expert opinions are consolidated to arrive at a compromise estimate of future. To be precise it basically involves the use of expert opinion through anonymous, interactive, controlled feedback among a group of participants (the expert panel). Normally the panel is polled by questionnaires in a search for opinions on reasonably well-defined issues. Each member responds with a forecast and reasons for it. These responses are then statistically compiled

and fed back anonymously to all members of the panel. This routine continues through subsequent interactions as the information is reprocessed by the experts and new forecasts are generated. Ideally the composite results will move towards a consensus. This technique is employed fairly widely in public and private sector planning. The key to Delphi technique lies in the coordinator and experts. The coordinator must be talented enough to synthesise diverse and wide ranging statements and arrive at both a structured set-off questions and a forecast.

- (iv) ***Econometric Models:*** The econometric models combine statistical tools with economic and business theories to estimate various economic variables and to forecast the intended variable. Basically the econometric models are designed as numerical interpretations of real-world systems (e.g., national economies, ecologies, production systems). They involve the estimation of theoretical and empirically based relationships, which, when taken together, interact quantitatively to produce forecast outcomes. Computers are normally used to make the calculations. An econometric model may be single equation regression model or it may consist of a system of simultaneous equations. The forecast made on the basis of econometric models are much more reliable as compared to other techniques. The unique advantage of this technique is the ability to perform sensitivity analysis where the analyst changes assumptions or estimations within the model to generate varying outcomes. For example, in a dynamic population forecasting model, one might wish to assess the impact of changes in personal income on population mobility. By varying the income variables in the model, the analyst examines this impact on whatever mobility variables the model contains, thus assessing their sensitivity to income changes. In doing so the analyst is able to evaluate the model itself, as well as gain some understanding of contingency outcomes. The econometric models used in actual practice are generally complex.
- (v) ***Cross-Impact Analysis Technique:*** It is a forecasting technique which is designed to assess the interactions among future environmental conditions. The analyst begins these exercises by assuming that a set of future environmental circumstances will come true (e.g., four new industry entrants, each holding a 5 percent market shares within six years). Through the use of matrix analysis, the analyst then attempts to assess the impact of these circumstances on the possibility and timing of others, (such as price competition). If nothing else, the analyst is able to expose forecasting inconsistencies and to clarify underlying assumptions in the forecasts themselves.
- (vi) ***Scanning and Monitoring Technique:*** These are forecasting techniques which involve future thinking. The scan is the equivalent of a 360-degree radar sweep, but monitoring is the choice for specific environmental variables or factors which are tracked over time. The latter merely helps to refine and make the gathering and processing of environmental information more efficient.
- (vii) ***Survey Technology:*** Under this technique, field surveys are conducted to

collect information on the intentions of the concerned people. The survey may be on census or sample basis. Under census survey all the units in the population are taken into account. In sample survey industry analysis, a selected subset of them are surveyed and through their study inferences about the whole population are drawn. Both quantitative and qualitative information may be collected by this technique. The information collected by this technique may be useful to identify and ascertain the attitudes of the consumers in regard to various items of expenditure and consumption. On the basis of such surveys, demand for various goods can be projected.

- (viii) **Business Barometer Technique:** Under this technique experts use economic indicators as barometer to forecast trends in business activities. The basic approach applied under this technique is to construct an index number of relevant economic indicator and to forecast future trends on the basis of movements in the index of economic indicators over the period. The indicators used in this technique are classified as:
- (a) Leading indicators consist of indicators which move-up and down a head of some other series;
 - (b) Coincidental indicators consist of indicators which move up and down simultaneously with the level of activity; and
 - (c) Lagging series indicators consist of indicators which follow-up a change after some time lag.

Index numbers are used to measure the stage of economy between two or more periods. These index numbers are used to study the trends, seasonal fluctuations, cyclical movements, and irregular fluctuations. These index numbers, when used in conjunction with one another or combined with one or more, provide indications as to the direction in which the economy is heading.

- (ix) **Time Series Analysis Technique:** It refers to an arrangement of statistical data in a chronological order in accordance with its time of occurrence. It basically reflects the dynamic pace of steady movements of phenomena over a period of time. Important variables of business interest include price, production, investment, consumption, national income, foreign trade and exchange reserves. Time series data on the relevant variable under forecast are used to fit a trend line or a curve graphically. Trend line can be worked out by fitting a trend equation to time series through least square method or some other estimation techniques. Time series analysis should be used as a basis for forecasting when data are available for a long period of time and tendencies disclosed by the trend and seasonal factors are fairly clear and stable. The time series of various indicators are selected on the basis of various criteria, such as economic significance of indicator, statistical adequacy of time series indicators, consistency of series, immediate availability of series etc.
- (x) **Regression Analysis:** Regression analysis is the most popular and widely applied forecasting technique used by the experts. It is a mathematical

analysis which reveals the relative movements of two or more interrelated series. It is used to estimate the changes in one variable as a result of specified changes in other variable or variables. Generally, the regression and correlation analysis is used for processing the statistical data and deriving a generalized mathematical relationship which, subject to a certain error, can be used for forecasting the expected values of the dependent variables in future if the values of independent variables are known. It is objective method which uses both time series and cross sectional data.

- (xi) **Input-Output Analysis:** Input-output analysis considers inter industry relationship in an economy depicting how the output of one industry goes to another industry where it serves as an input and thereby makes one industry dependent on another both, as customer of output and as supplier of inputs. An input-output model is a specific formulation of input-output analysis. According to Watson, input-output analysis is the statistical measurement of the inputs and outputs of all industries taken together in an interdependent system of commodity flows. It is based on certain set-off assumptions.

LIMITATIONS OF FORECASTING

Forecasting is an essential ingredient, but it should not be understood that it is the only element of the strategic planning process in the organization. Forecasting provides sound base for assuming the behaviours of certain events but that may not be fully correct on account of certain limitations which are discussed as under:

1. **Set of Assumptions or Axioms:** Environmental forecasting exercises used by business strategists are some times based on ideal sets of assumptions which are not always true. Forecasting merely suggests that if an event has happened in a particular way in the past, it will happen the same way in the future. It is because events do not change haphazardly and speedily but change on a regular pattern. This assumption may not hold good in all the situations, there are multiple factors which influence the occurrence of an event. The practically pattern of all these factors may not be similar. Thus, a slight change in a particular factor or variable may be so unpredictable and important that it may affect the total business situation scenario in the industry.
2. **Inadequate Reliability of Forecast:** Forecasts are not always correct or reliable. They merely indicate and guide towards the trend and directions of future events because the factors which have been taken into account for making forecasts are also influenced by human factor which is highly unpredictable. Multiple techniques of forecasting suggest the relationship among various known facts. They can project the future trends, but cannot guarantee that this would happen in future. Longer the period of forecasting, higher the degree of error. Hence, it has been commented by experts that the only thing you can be sure about any forecast is that it will contain some error.
3. **Time and Cost Factor:** Time and cost factor is another limitation of forecasting. While the above factors speak of limitations inherent in

forecasting, time and cost factor suggest the degree to which an organization will go for formal forecasting. Formal forecasting by an organization is subject to availability of time and financial resources and cost benefit analysis. For making forecast of any event, certain information and data are required. Some of these may be in highly disorganized form; some may be in qualitative form. The collection of information and conversion of qualitative data into quantitative ones involves a lot of time and money. Therefore, managers have to trade off between the cost involved in forecasting and resultant benefits. This is the reason why most of the smaller organizations do not go for formal system of forecasting.

Thus, the applications and usefulness of forecasting techniques for a business organization depends on the purpose of forecasting and the availability of reliable and relevant data and value judgements.

Forecasting is not crystal ball gazing. It is conjecture. The analyst must be ready to revise forecasts as necessary so that appropriate strategy adjustments can be considered. A forecast that is right in its substance but wrong in its timing can destroy attempts to attain goals. Understanding the present and anticipating the future are key ingredients of strategic management.

INDUSTRY ANALYSIS

Industry analysis complements analysis of the other dimensions of a firm's environment. It focuses on the industries in which the firm competes. The breadth and depth of industry analysis and the boundaries for information gathered are defined by these industries. Thus, industry analysis involves the same processes as those identified for environmental analysis, except that it logically must be preceded by identification of the appropriate industries for analysis along with descriptions of the various characteristics of those industries.

Industry analysis is relevant in any of these situations:

1. The firm's strategy defines the business in terms of specific industries.
2. The firm is facing new forms of extra-industry competition.
3. The firm is contemplating entry into a new industry.

An industry perspective offers the basis for gaining familiarity with the products, competition, resource requirements, and constraints peculiar to a line of business. The industry perspective must be used cautiously since an individual firm or business unit can hardly be considered completely protected from direct extra-industry influences.

Illustration:

Relaxation in occupational safety and health standards for an industry may come at the same time that an individual firm is singled out for stricter compliance enforcement. The analyst, therefore, is cautioned to assess direct environmental influences as well as the portion of the environment that affects overall industry conditions.

Michael E. Porter developed an assessment model for analyzing industry

structure that focuses on the forces imposed on the process of competing by five influences: the intensity of rivalry among competitors, the threat of new entrants, the threat of substitute products, the bargaining power of suppliers, and the bargaining power of buyers or customers. This "Five Forces Model" is described below.

Multiple product/service firms, particularly those that are diversified, will often hold "membership" in more than one industry. This will obviously require multiple analyses and creative cross-cutting of industries in the compilation and analysis of data.

In general an industry is nothing more than a cluster of economic units (firms or business units) that are grouped together for analytical or cooperative purposes. Trade associations are the purest manifestation of the latter purpose. Trade associations themselves define criteria for membership and establish networks for information sharing and cooperation. Porter has identified five basic forces that collectively describe the state of competition in an industry.

PORTER'S FIVE FORCES MODEL OF INDUSTRY ANALYSIS

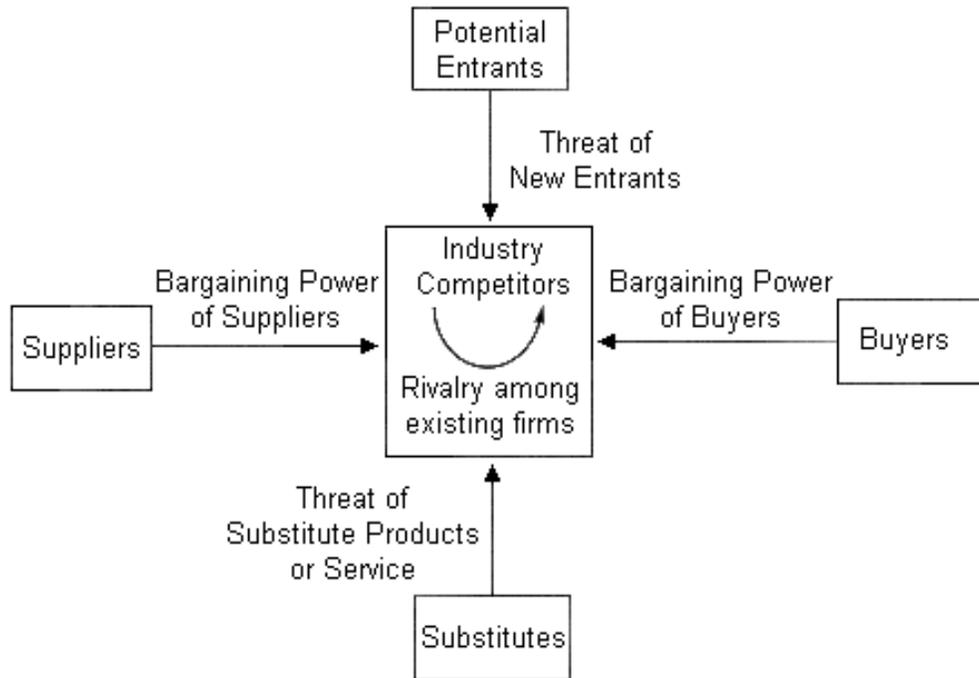
The nature of competition in an industry in large part determines the content of strategy, especially business-level strategy. Based as it is on the fundamental economics of the industry, the very profit potential of an industry is determined by competitive interactions. Where these interactions are intense, profits tend to be whittled away by the activities of competing firms. Where they are mild and competitors appear docile, profit potential tends to be high. A full understanding of the elements of competition within an industry can be obtained by analyzing following factors:

1. Intensity of rivalry among competitors
2. Threat posed by potential entrants to the market
3. Bargaining power possessed by the firm's/industry's suppliers
4. Bargaining power possessed by the firm's/industry's customers
5. Threat to a firm's/industry's products by potential substitutes.

All these forces assist in identifying the presence or absence of potential high returns. The weaker is the forces, the greater is the opportunity for firms in an industry to experience superior profitability. The clear understanding of these forces and their influences on competition within an industry enables the strategist to identify the most advantageous strategic position. The player within an industry on whom these forces exert pressure are, the industry's competing firms themselves, potential new entrants to the industry's markets, suppliers (vendors), customers, and makers of substitute products respectively.

For conducting an analysis of the five forces of competition, the starting point is to identify all the competitors, potential new entrants, major suppliers, customers, and makers of and nature of substitute products. Competitors would not only have to be identified, but various distinguishing data about the industry would also have to be specified. For each competitor, this data would include the information about market share, product line differences/similarities, market segments served, price/quality relationships represented by products, growth/decline trends, financial strength differences, and any other information that help to describe the industry.

The five forces and the major players within an industry are depicted in the following diagram as follows:



Porter's Five Forces Model

Using Porter's model to analyze an industry for a particular firm, involves estimating the strength of each force, identifying its underlying source, and then formulating a strategy that will create an advantage for the firm. An advantage could be established by defining a position from which to defend itself against strong forces somewhere in the model, drafting an offensive posture to take advantage of weak forces in the industry, or designing a way to favorably alter the forces.

The key task of the analyst is to understand the underlying causes of each of the competitive forces at work. With this knowledge, a company's strengths or weaknesses can be clarified, and the most fertile areas for drafting competitive thrusts can be defined. Also, knowing the magnitude of competitive forces allows the strategist to identify the most important trends that are emerging as opportunities and threats.

The five forces that can create strength for competitors are explained below:

(i) Intensity of Rivalry among Competitors: Some industries appear inactive because of a low level of rivalry among competitors. An example might be industrial fasteners, the manufacturers of nuts and bolts and other devices used to connect the components of products. A large number of quite small manufacturers accept low levels of profitability for staying in business. Competition is key with little effort and

expense devoted to differentiating brands or single products. Such firms often produce a catalog and send representatives to trade shows to demonstrate products, or use sales forces or independent sales representatives for selling. They usually compete on the basis of price, delivery times, or the convenience of either large or small lot sizes. However, there are virtually no screw manufacturing companies advertising on television.

They make advertisement, appeals, posters, jingles, demonstrations, sales, and many other types of promotional and advertising program differentiate their product on the basis of attributes and their strength of the product.

Some of the factors responsible to precipitate intense rivalry in an industry are listed as under:

- Size and power among a large number of competitors;
- Slow or stagnant growth of industry demand;
- Undifferentiated products and low switching costs;
- High fixed costs or product perishability;
- Capacity additions generate large volume increases which raise pressure to cut prices;
- High exit barriers which compel firms to bear low or negative returns on investment;
- Wide spectrum of strategies and types of firms which generates as a result of confusion and frequent collisions in the market.

(ii) Power of Buyers: From an industry's point of view, the buyers can usually be classified into three major categories i.e., consumers, industrial customers, and commercial customers. Consumers include the purchasers of the firm's service or product for their own use.

Illustration:

Goodyear, sells tyres directly to the people who use them in their cars and two wheelers. Industrial buyers include the companies which purchase the firm's product or service to be used as a component in its product. The automobile manufacturers who put Goodyear tyres on new cars would be one group of its industrial buyers. Commercial customers include other companies that sell Goodyear's products to consumers.

Buyers, whether consumers, industrial, or commercial, can enjoy positions of strength over the firm from which they purchase products by superior bargaining power.

Illustration:

A large retailer (commercial buyer) with a loyal customer base and high volume of sales of the product in question may be able to virtually dictate price, shipping arrangements, order quantity, quality level, and other factors to its vendors.

On the other hand, an automobile manufacturer could have a powerful bargaining position over a tyre maker or the entire tyre industry if a large volume of tyres was sought for installation on a popular auto line. Of course, the tyre maker would prevent itself from becoming too dependent on one buyer by strenuously developing similar relationships with other companies. Toyota uses multiple sourcing—buying from several producers of the same components—to prevent dependency on too few suppliers. Thus, it has a strong bargaining position on matters of price, quality, delivery times, etc., as its suppliers compete with one another to gain favour with its buyers.

An industry's buyers tend to be powerful relative to the firms in the following conditions:

- When the buyers are concentrated, or they account for a large volume of purchases.
- Products are undifferentiated or standardized.
- The seller's component represents a large portion of the total cost of the buyer's finished product. When the seller's product has a small cost share, buyers tend to be less price sensitive.
- Buyers are earning low profits and are thus more price sensitive than if they were highly profitable.
- The sellers' product is not critical in one way or another to the buyer. If it's critical to the quality, price, appeal, etc., of an industrial buyer group's finished product, then the sellers will have power over the buyers.
- There is a threat that buyers can integrate backward to make the suppliers' product.

An industry's commercial buyers (retailers) have, in some cases, an additional source of bargaining power over their manufacturing vendors. They can influence customers' purchase decisions. This capability allows retailers to gain price, delivery time, order quantity, and other concessions from their suppliers that other classes of buyers might not receive.

(iii) Power of Suppliers: The suppliers of goods and services to an industry have the power to influence their customers through their ability to set price and control quality, delivery time, and order quantity. If these customers cannot manage successfully one supplier against another to protect their interest, then the industry's profits can be drained off by the suppliers.

The power of suppliers is high in the following situations:

- Few suppliers who are more concentrated than their customers.
- Differentiated suppliers' product.
- High customers' switching costs.
- Little pressure on suppliers to protect themselves from substitutes or replacements for their product.
- Suppliers' capability to integrate forward.
- When the industry is not one of the major customers of the supplier. Important customers would be protected from aggressive moves by the supplier because of their mutual interests.

(iv) Substitute Products: Substitute products refer to those products of industries which serve similar consumer needs. Existence of close substitutes represents a strong competitive threat which limits the price fixation power and the profitability of the firm. Conversely, if the firm's products have very few substitutes, then the company has the opportunity to raise prices and earn additional profits. It is an eye opener for the firms to select those lines which have least substitutes.

Manufacturers of products and suppliers of services must constantly scan their environments for the potential emergence of substitutes for their product. Thus the most dangerous substitutes are those which show potential for improving price-performance trade-offs and those made by firms or industries earning high profits. In these cases, strategies must be formulated to protect against displacement by the substitute product/service.

(v) Potential Entrants: New entrants to an industry pose several threats to existing competitors. New competitors can reduce the market share of all participants by dividing the pie into more pieces. As a result of this they may also bring new technology or greater resources not available to present competitors and capture a high market share position quickly to the detriment of all existing participants.

The threat of new entrants to an industry is high in a situation when barriers to entry are low or restricted. Low entry barriers emerge generally applies in the following situations:

- *Low economies of scale.* When small independent fast food outlets exists side-by-side with the units of national chains of fast foods, it indicates that there are few economies of scale in this industry.
- *Undifferentiated products in an industry lead to new entrants.*
- *Low capital requirements:* When the capital requirement for starting-up a business in an industry is low, it offers the opportunity to new entrants to joint the trade. An example is the house painting business where capital costs are minimal.
- *Low switching cost:* When the customers finds that there is low switching cost to change the supplier and little incentive to stay with the existing supplier, all this leads to new entrants. Cell phone users frequently change from one company to other because there is very low switching costs and little incentive to stay with current provider.
- *Easy access to distribution channels.*
- *Low familiarization costs.*

Thus, conducting an industry analysis following Porter's model involves collecting data and developing explanations for the ways in which industry competition is affected by the five forces.

STRATEGIC GROUP MAPPING

Strategic group mapping is another important tool to look at external environment, especially the competition. The firms which constitute an industry are not alike. They have different products, market shares, life cycle stage, profitability, and so on. Indeed, each one has a different strategy, at least in its details. But there

are always some similarities. There may be several people who are striving to be market leaders. Some may be pursuing low profit margin-high volume pricing. Others may have succeeded in lowering per unit costs, or creating a high-value-for-price image in the market. They may consist of several groups that represent different extents of geographical coverage or breadth of product line.

Depending on what similarities exist, industry participants can be organized by them into a set of strategic groups. For mapping strategic groups, the best bases for organizing participants are key dimensions of competition. By arranging competitors according to two key competitive factors on a two-dimensional chart (where each axis represents one of the factors), their relative positions on those factors can be analyzed. Then conclusions about market openings and closed segments can be drawn so that the analyst can plan offensive or defensive moves.

The following steps are involved in the construction of strategic group mapping:

- (i) Identification of two important competitive characteristics which strategically differentiate firms in an industry from one another;
- (ii) Plot the firms on the two-variable map;
- (iii) Draw circles around the firms that are clustered together;
- (iv) Indicate potential movement of firms with arrows.

The exercise of strategic group map is supported by the users because of its following merits:

- (i) Identification of major and indirect rivals;
- (ii) Picturing the competitive playing field;
- (iii) Identification of open niches;
- (iv) Identification of competitor moves;
- (v) Improved understanding of differential effects of external trends;
- (vi) Identification of better/worse positions.

Despite several merits, the strategic group maps exercise possesses the following major limitations:

- (i) It is more useful in fragmented industries;
- (ii) It is often difficult to meaningfully use it in consolidated industries;
- (iii) It is only two-dimensional;
- (iv) It offers a macro view of competitive rivalry;
- (v) It does not provide clear role of mobility barriers (which restrict movement between groups).

SYNTHESIS OF EXTERNAL FACTORS

Once the data about different environmental variables such as economic, technological, legal, political, socio-cultural, global, and the industry in which firm

operates is collected, a number of external factors which are important to the firm will be identified. The manager can refine the analysis of these factors by classifying these factors into opportunities and threats.

Subsequently, for each of these external factors, the manager should indicate its importance to the business. Finally, the manager needs to assess how well the business is responding to each factor.

The "External Factors Analysis Summary (EFAS)," developed by Hunger and Wheelen provides a format for completing a synthesis of the factors from the external environment that have been identified.

The following steps are used to complete the EFAS table:

- In column 1 (External Factors) list the 8 to 10 most important opportunities and threats facing the business.
- In column 2 (Weight), assign a weight to each factor from 1.0 (most important) to 0.0 (not important) based on the factor's probable impact on the company's current position. The higher the weight, the more important this factor is to the current and future success of the business. It may be noted that all weight must add upto 1 irrespective of number of strategic factors.
- In column 3 (Rating), assign a rating to each factor from 5 (outstanding) to 1 (poor) based on the business's response to that particular factor. Each rating is a judgment regarding how well the business is currently dealing with each external factor (5 = outstanding, 4 = above average, 3 = average, 2 = below average, 1 = poor).
- In column 4 (Weighted Score), multiply the weight in column 2 for each factor with rating in column 3 to obtain that factor's weighted score. This results in a weighted score for each factor ranging from 5.0 (outstanding) to 1.0 (poor) with 3.0 as average.
- In column 5 (Comments), note why a particular factor was selected and how its weight and rating were estimated.

Finally, add the weighted scores for all the external factors in column 4 to determine the total weighted score. The total weighted score indicates how well the business is responding to current and expected factors in its external environment. The score can be used to compare that firm with other firms in the industry. The total weighted score for an average firm in an industry is always 3.0.

The number 3 indicates that neither your firm is well positioned nor it is poorly positioned. It is just an average. A number higher than 3 would mean that business is doing well. A business with an overall rating of five would be responding to the respective environment in an outstanding way. It may be noted that your business does not benefit from doing an activity well or having a skill or resource if that activity/skill/resources is not important.

INTERNAL SCANNING OF THE FIRM

Business firms after making an exhaustive scanning of the external environment in general and the industry in which the firm operates in particular, strategic planning

or management requires an in-depth appraisal and analysis of the firm. Scanning of the external environment and the industry analysis gives an idea about the external opportunities and threats provided or posed by the environment whereas internal scanning of the firm is the process of reviewing organizational resources, scanning organizational activities and linking them with creations of value of the organization and identifying the strengths and weaknesses. Internal analysis in general involves two stages:

- (1) Internal financial analysis, and
- (2) Internal functional analysis.

INTERNAL FINANCIAL ANALYSIS

The analysis of financial statements reveals much about a firm's operating strengths and weaknesses. They also serve as a basis for predicting the future financial developments. The performance of all parts of an organization is ultimately reflected in the magnitude of entries in a firm's financial statements; hence financial statement analysis can structure or bound the question of how well a strategy is working.

Comprehensive financial analysis in an organization basically consists of four elements: ratio analysis of the firm's historical financial performance, interpretation of cash flow position, analysis of retained earnings position, and predictions of future financial statements.

All findings and influences of the financial analysis should be reduced to strengths and weaknesses of the firm and located accordingly in the data set for the present time frame. Subsequently, the expected changes in each item can be forecasted.

Financial ratio analysis is an important tool of financial management, a process whereby the analyst or manager determines the degree of financial health represented by the firm's financial statements. This technique is useful in the following ways:

- (i) It helps experts in interpreting and evaluating income statements and balance sheets by reducing the amount of data contained in them to a workable amount. After computing several key ratios whose numerators and denominators are made up of selected items from the statements, a comprehensive analysis of the firm's financial position can be conducted by evaluating the resulting ratios.
- (ii) Financial ratio analysis can make financial data more meaningful. A ratio strikes a relationship between the numbers in its numerator and denominator. By selecting sets of numbers that are logically related, only a few ratios may be necessary to comprehensively analyze a set of financial statements.
- (iii) Ratios enables to determine the relative magnitudes of financial quantities. For example, the magnitude of a firm's debt has little meaning unless it is compared with the owner's investment in the business. Thus, the debt/equity ratio strikes a relationship between these quantities such that their relative magnitudes can be established.

Because of the above mentioned advantages, financial ratio analysis can help the managers or external analysts make effective decisions about the firm's credit worthiness, potential earnings, and financial strengths and weaknesses. It basically involves simply selecting the financial entities to be compared from either the income statement or the balance sheet, dividing one by the other, and comparing the product with a base. This comparative base could be a history of ratios for the firm (trend analysis), average ratio values from past periods computed from financial statements of other firms in the same industry (industry average comparison), or a combination of the two.

The financial structure of a business has several dimensions. Each financial dimension may be measured using several ratios, but the financial dimensions themselves normally are not directly measurable. To analyze a firm's financial structure comprehensively, one must select a set of ratios made up of subsets, each of which represents a dimension. A brief detail of different types of financial ratios used by experts to understand the financial health of an organization are discussed as under:

LIQUIDITY: The liquidity of a firm is its ability to pay its current liabilities as they become due (current liabilities are debts due within one year). The only funds available for payment of short-term debt are either cash or other current assets readily convertible into cash. Consequently, liquidity is measured by ratios that strike a relationship between current liabilities and selected current assets.

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

Current assets refer to those assets which are normally expected to flow into cash in the course of a merchandising cycle. Ordinarily, they include cash, notes and accounts receivable (due within the next twelve months), inventory, and marketable securities (at current realizable values).

Current liabilities on the other hand, are short-term obligations of the company for the payment of cash due on demand or within a year. Ordinarily, they include short-term notes and accounts payable for merchandise, current portion of long-term debt, taxes due, and other accruals.

This ratio basically is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater is the cushion between current obligations and a firm's ability to pay them. The stronger ratio always reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets are a critical factor in the analysis of a firm's liquidity.

$$\text{Quick Ratio} = [\text{Cash} + \text{Marketable Securities}] / \text{Current Liabilities}$$

It is also known as the "acid test" ratio. This is a refinement of the current ratio and is a more conservative measure of liquidity. This ratio expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than one to one implies a reciprocal "dependency" on inventory to liquidate short-term debt.

COVERAGE: It refers to a firm's ability to service debt which involves interest or premium payments. Ratios which measure coverage consist of one component to estimate flow of funds into the firm and another for periodic payments on debt.

EBIT to Interest = Earning Before Interest and Taxes/Annual Interest Expense

This ratio is a measure of a firm's ability to meet interest payments. A high ratio may indicate that a borrower would have little difficulty in meeting the interest obligations of a loan. This ratio also serves as an indicator of a firm's capacity to take on additional debt.

Cash flow to current maturities = Net profit plus depreciation, depletion, and amortization expenses/Maturities of long-term debt and Current portion of long-term debt.

This ratio basically expresses the coverage of current maturities by cash flow from operations. Since cash flow is the primary source of debt retirement, this ratio measures the firm's ability to service debt repayment and is an indicator of additional debt capacity. Although it is misleading to think that all cash flow is available for debt service, but the ratio is a valid measure of the ability to service the long-term debt.

PROFITABILITY: This dimension of a company's financial structure reveals management's ability to control expenses and to earn a return on committed funds. Ratios which measure profitability usually consist of a profit element and one that represents the amount of funds invested in whatever aspect of the firm is of interest to the analyst.

Net profit can be calculated either before or after taxes. The analyst should ensure that the ratio elements used to compute the profitability ratios are the same as those used to compute the industry average against which the ratio's value will be compared.

Gross Profit Margin = Sales minus Cost of Goods Sold/Sales

Interpretation: The total margin available to cover operating expenses and yield a profit.

Operating Profit Margin = Earning before Interest and Taxes/Sales

Interpretation: It shows profitability without concern for taxes and interest.

Net Profit Margin = Net Profit/Sales

Interpretation: It shows profit after tax per rupee of sales.

Return on Assets (ROA) = Net Income/Total Assets

Interpretation: This ratio expresses the return on total assets and measures the effectiveness of management in employing the resources available to it. If a specific ratio varies considerably from the ranges found in published sources, the analyst will need to examine the makeup of the assets and take a closer look at the earnings figure. A heavily depreciated plant and a large amount of intangible assets or unusual income or expense items will cause distortions of this ratio.

Return on Shareholders' Equity = Net Income/Total Shareholders' Equity

It shows after tax profits per rupee of shareholder's investment in the firm.

$$\text{Earning Per Share (EPS)} = \text{Net Income/Number of Outstanding Shares}$$

It shows earning available to the owners of the common stock of the company.

$$\text{Price Earning Ratio} = \text{Market Price per Share/Earning per Share}$$

It shows attractiveness of firm on equity markets.

SOLVENCY (LEVERAGE): The extent to which the firm relies on debt as opposed to owner's capital (net worth) is its leverage position. A highly leveraged firm is one with a high proportion of debt relative to owner's investment. Some of the important ratios in this regard are discussed as under:

$$\text{Debt to Equity Ratio} = \text{Total Debt/Total Shareholders' Equity}$$

This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. A lower ratio generally indicates greater long-term financial safety. A firm with a low debt/networth ratio usually has greater flexibility to borrow in the future. A more highly leveraged company has more limited debt capacity. Generally the order or preference given to this ratio is arranged on a continuum such that a low negative ratio is characterized as a weak debt/networth position and a high positive ratio value is perceived as a strong debt/networth position.

$$\text{Fixed Assets to Net Worth} = \text{Net Fixed Assets/Tangible Net Worth}$$

This ratio measures the extent to which owner's equity (net worth) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth, and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation.

$$\text{Debts to Total Asset Ratio} = \text{Total Debts/Total Assets}$$

It shows the total funds that are provided by creditors.

$$\text{Long Term Debts to Equity Ratio} = \text{Long Term Debts/Total Shareholders' Equity}$$

It shows the balance between debt and equity in a firm's long term capital structure.

ACTIVITY RATIOS: Activity ratios, also called efficiency or turnover ratios, measure how effectively a firm's assets are managed. Examining the relationship between a measure of sales and an asset account is their purpose. Some of these ratios are discussed as under:

$$\text{Inventory Turnover} = \text{Sales/Inventory of Finished Goods}$$

This ratio measures the number of times inventory is turned over during the year. High inventory turnover can indicate better liquidity or superior marketing. Conversely it can indicate a shortage of needed inventory for sales. Low inventory turnover can indicate poor liquidity, possible overstocking, obsolescence, or, in contrast to these negative interpretations, a planned inventory build-up in preparation for future material shortages. A problem with this ratio is that it compares days inventory (at the end of the accounting period) with cost of goods sold and does not take seasonal fluctuations into account. One way to resolve this problem is to calculate cost of

sales and average inventory by month to develop turnover ratios for each month, when sufficient data are available.

$$\text{Fixed Assets Turnover} = \text{Sales}/\text{Fixed Assets}$$

This ratio is a measure of the productive use of a firm's fixed assets. Largely depreciated fixed assets of a labor-intensive operation may cause a distortion of this ratio.

$$\text{Total Assets Turnover} = \text{Sales}/\text{Total Assets}$$

This ratio is a general measure of a firm's ability to generate sales in relation to total assets. It should be used only to compare firms within specific industry groups and in conjunction with other operating ratios to determine the effective employment of assets.

$$\text{Working Capital Turnover} = \text{Net Sales}/\text{Working Capital}$$

Working capital is a measure of the margin of protection for current creditors. It reflects the ability to finance current operations. Relating the level of sales arising from operations to underlying working capital measures how efficiently working capital is employed. A low ratio may indicate an inefficient use of working capital, whereas a very high ratio often signifies overtrading, a vulnerable position for creditors.

$$\text{Receivables Turnover} = \text{Annual Credit Sales}/\text{Accounts Receivable}$$

This ratio measures the number of times accounts and trade receivable turn over during the year. A problem with this ratio is that it compares day's receivables, shown at statement date, with total annual net sales and does not take seasonal fluctuations into consideration. When there are a large proportion of cash sales to total sales, it may give misleading results.

As with inventory turnover, it may prove useful to make these calculations by month so that seasonal fluctuations can be accounted for.

$$\text{Average Collection Period} = \text{Accounts Receivable}/(\text{Total Credit Sales}/365)$$

This figure expresses the average time in days that receivables are outstanding. Generally the greater the number of days outstanding, the greater is the probability of delinquencies in accounts receivable. A comparison of a company's daily receivables may indicate the extent of a company's control over credit and collections. The terms offered by a company to its customers, however, may differ from terms within the industry, and should be taken into consideration. Again the distinction between cash sales and credit sales may prove useful in calculating this ratio.

INTERNAL FUNCTIONAL ANALYSIS

Most strategic operating characteristics are manifested either directly or indirectly as symptoms in a firm's financial statements. These symptoms must be identified and then interpreted in operational terms for strategic analysis. Through the interpretation of operational causes of financial symptoms, the strategist can identify many of the firm's strengths and weaknesses. But there is a temptation to spend too much time on the analysis of financial performance and position and not enough time is spent on the more difficult analysis of the underlying factors. These underlying

factors are usually the strengths and weaknesses uncovered during analysis of other functional areas. In other words, financial analysis can reveal symptoms of problems or evidence of strengths in the other functional areas. It can also indicate certain environmental factors affecting performance.

Therefore, financial analysis can be viewed as a way to uncover questions about performance, to which the answers are likely to be found by analysis of other functional areas. For example, if financial analysis showed relatively high gross profits for a firm experiencing declining sales, the analyst would probably turn to either its marketing function (to determine if prices charged by the firm were too high) or its production systems (to see if raw materials inventory costs were leading to excessive cost of goods sold). Similarly, where gross profit is average but net (operating) profit is low, the analyst would likely find some operating expense accounts that were unusually large. These excessive accounts should then be traced back to the functional areas generating them to find evidence of inefficiencies.

There are two fundamental ways to conduct an internal functional analysis i.e. vertical and horizontal. For the vertical approach, strengths and weaknesses are identified at each organizational level. The horizontal analysis corresponds to the functional areas of the organization strategic business units. Strengths and weaknesses are identified for each function. In this case horizontal approach is preferred because it seems to be more universally applicable. Analysis can be focused on functional departments, or whatever basis of departmentalization has been used in a particular organization.

The major dimensions of each area are intended as beginning points for analysts to formulate their own evaluation systems for each case study or organization analyzed.

Stevenson found that managers seem to use three types of criteria in identifying strengths and weaknesses: historical, competitive, and normative. Analyzing functional areas by historical criteria means comparing present values with their historical counterparts and identifying strengths and weaknesses on the basis of those comparisons. Competitive comparisons involve assessing similarities and dissimilarities with successful competitors and finding strengths and weaknesses accordingly. Similarly normative comparisons are those where present characteristics are compared with ideal values as perceived by the analyst or an expert opinion.

In practice the process of identifying strengths and weaknesses may be one of the most educational experiences the top managers perceive especially the enumeration and discussion of weaknesses. Since the responsibility for the performance of organization and functional departments often rests with single managers, identification of weaknesses at these levels can be painful and embarrassing for him. The discussions must be handled carefully to prevent alienation and to bring about constructive solutions to whatever problems are revealed. However, the analyst must make sure that all the weaknesses are identified, even though feelings of some may be hurt.

An analysis of the functional areas involves the following major steps:

1. Comprehensively identify the major functional areas that make up organizations operations.

2. Enumerate the critical operational factors of each functional area.
3. Identify both qualitative and quantitative variables to describe performance of the organizations on each operational factor.
4. Conduct research to assign either qualitative or quantitative values to the variables identified in (3) above.
5. Organize findings by function according to whether they represent strengths or weaknesses.

IDENTIFICATION OF MAJOR FUNCTIONAL AREAS

Whatever organization is analyzed, the analyst should select a comprehensive set of categories that define the firm's operations. These categories, or functional areas, can vary from one organization to another and depend upon whether the analyst is conducting a vertical or a horizontal analysis. A horizontal analysis of the common functional areas of marketing, personnel, production and research and development along with organization structure, present and past strategies has been outlined below:

Marketing

Consistent with marketing convention, this function is analyzed by examining the operating characteristics of the organizations' products/services, price, promotion, distribution, and new product development systems. Interest is focused on all aspects of each of these systems that have not already been identified as part of the financial analysis. Examples of checkpoints for each aspects are as follows:

- Products/services — Market share; penetration; quality level; market size; market expansion rate; etc.
- Price — Relative position; image; relationships to gross profit margin; etc.
- Promotion — Effectiveness; appropriateness of emphasis; budget as percent of sales; measurable acceptable return.
- Distribution — Delivery record; other appropriate methods; unfilled orders; costs
- New product development — New product introduction rate; effective sources of ideas; extent of market feedback; success rate; etc.

Personnel and Union Relations

The overall purpose of the personnel function is to manage the relationship between employees and the organization. Therefore, internal analysis of the personnel function is an assessment of the strengths and weaknesses of that relationship. This function can be analyzed by examining the following factors:

1. Job analysis factors—Necessary skills; all necessary jobs; selection and placement of effective system; recruiting capability; training effectiveness.
2. Job evaluation factors—Appropriate pay scales; adequacy of benefits.
3. Turnover rate.
4. Absenteeism rate.

5. Attitude of employees, managers.
6. Seasonal factor.
7. Performance evaluation.
8. Union-management relations—Unions representing employees; bargaining positions; quality of relations; negotiation schedule, etc.

Production

The production or manufacturing area's strengths and weaknesses relate to the organization's ability to produce its products/services at the desired quality level on time at the planned costs. Evaluative factors for production may cover the following:

1. Facilities and equipment—Capacity level; per-unit costs of manufacturing; obsolescence; level of technology; process optimality; replacement and maintenance.
2. Quality level—Defective units; inspection costs; re-manufacturing costs; competitive position; consistency.
3. Inventory—Turnover level; costs and trends.
4. Procurement—Sources; quality of inputs; constant lead times.
5. Planning and scheduling.

For most service organizations, the process of providing the service can be roughly equated to the production of a product. Costs of providing the service, as well as quality of the service delivered, can be the focus of analysis.

Research and Development

Research and development (R&D) provides the technical analysis and support to other departments, and designs, products or processes to meet market needs and thereby generate a profit. Operation of R&D must strike a balance between practicality and creativity in order to contribute successfully to profit goals. Over-emphasis on practical matters can impair future profitability because few innovations will be generated. The correct balance between creativity and practicality for a particular firm is a strategic issue that cannot be decided absolutely.

An internal analysis of the R&D function thus involves identifying strengths and weaknesses in terms of the following:

- Demand for R&D.
- Facilities and equipment.
- Market and production inputs.
- Planning and scheduling.

Organization

Organization structure must support strategies and facilitate their successful implementation. The structure must prevent any problems from materializing. Changing structure is risky. Therefore, it should not be tampered with unless there is either a problem present that must be corrected or one that can reasonably be

expected to develop if a change is not made. In either case, organization structure should be changed only because of specific problems. In fact there is no absolutely best structure, but only the structure that minimizes organization-related problems.

Some of the criteria that can be used to analyze organization structure are as follows:

- Appropriate structure—Structure levels; communication channels; expeditious communication; forms of organization used, etc.
- Accountability and control—Fixation of responsibility; multiple functions to individuals; number of committees, etc.

TOOLS AND TECHNIQUES OF STRATEGIC MANAGEMENT

Strategic planners and experts uses different types of tool and techniques in strategic planning process to understand overall external and internal environment of business organization. Some of these tools/techniques are discussed as under:

SWOT ANALYSIS

SWOT Analysis, is a strategic planning tool used to evaluate the Strengths (S), Weaknesses (W), Opportunities (O), and Threats (T) involved in a project or in a business venture. It basically involves specifying the objective of the business venture or project and identifying the internal and external factors that are favorable and unfavorable for achieving the objective.

SWOT ANALYSIS		
	HELPFUL In achieving the objectives	HARMFUL In achieving the objectives
Internal origin	Strengths	Weaknesses
External origin	Opportunities	Threats

Illustrative diagram of SWOT analysis (SWOT Matrix)

In SWOT analysis Strengths, Weaknesses, Opportunities and Threats can be understood as:

- Strengths: Attributes of the organization that are helpful in achieving the objective.
- Weaknesses: Attributes of the organization that are harmful in achieving the objective.
- Opportunities: External conditions that are helpful in achieving the objective.
- Threats: External conditions that are harmful in achieving the objective.

The aim of any SWOT analysis is to identify the key internal and external factors which are important to achieving the objective.

- Internal factors – The strengths and weaknesses internal to the organization.
- External factors – The opportunities and threats presented by the external environment.

The internal factors may be viewed as strengths or weaknesses depending upon their impact on the organization's objectives. What may represent strengths with respect to one objective may be weaknesses for another objective. The factors may include all of the 4P's; i.e., product, price, place (distribution) and promotion as well as personnel, finance, manufacturing capabilities and so on. The external factors may include macroeconomic matters, technological change, legislation, and socio-cultural changes, as well as changes in the market place or competitive position. The results are often presented in the form of a matrix.

Identification of SWOT is essential because subsequent steps in the process of planning for achievement of the selected objective may be derived from the SWOT. The decision makers have to determine whether the objective is attainable, given the SWOT. If the objective is not attainable a different objective must be selected and the process is repeated.

In case the objective seems attainable, the SWOT is used as inputs to the creative generation of possible strategies, by asking and answering each of the following four questions:

- How can we use each Strength?
- How can we stop each Weakness?
- How can we exploit each Opportunity?
- How can we defend against each Threat?

Ideally, a cross-functional team or a task force which represents a broad range of perspectives should carry out the SWOT analysis. For example, a SWOT team may include an accountant, a salesperson, an executive manager, an engineer, and an ombudsman. SWOT analysis is just one method of categorization and has its own weaknesses. For example, it may tend to persuade companies to compile lists rather than think about what is actually important in achieving objectives. It also presents the resulting lists uncritically and without clear prioritization so that, for example, weak opportunities may appear to balance strong threats. The importance of

individual SWOTs will be revealed by the value of the strategies it generates. A SWOT item that produces valuable strategies is important.

The merit of SWOT analysis is not limited to profit-seeking organizations. SWOT analysis may be used in any decision-making situation when a desired end-state (objective) has been defined. SWOT analysis may also be used in pre-crisis planning and preventive crisis management.

Illustration:

THINKING STRATEGICALLY: A CASE OF HINDUSTAN PRO SPORTS

Identification of factors that characterize a company's strategic situation is critical in the strategic process. These factors can be classified as (SWOT) (p.65). Analysis of these factors with the help of various tools will enable a manager to formulate strategies more effectively. In this case, you would be able to determine long-term objectives for a sports bicycle manufacturing company (HINDUSTAN PRO SPORTS) on the basis of internal and external information. Keeping in view the long-term objectives, you may isolate the strength, weaknesses, opportunities and threats relating to the company. You may then use a tool known as Matched Pair Analysis to identify strategies that the company may use to achieve its long-term objective. Matched Pair Analysis can be combined with SWOT Analysis to match the internal strengths and weaknesses of the company with its external opportunities and threats. Consequently, it becomes possible to ascertain more strategic alternatives.

Chairman's Views:

The Chairman of Hindustan Pro Sports wants his company to emerge as the number 1 specialty bike retailer in India in terms of revenue within the next five years. The management so far has been unable to make any unanimous choice. The Chairman however, would alternatively like the company to become No.1 specialty bike retailer in India in terms of number of stores.

CEO's Views:

The CEO of the company however, has a focus on profitability rather than the competitive portion. He wants Hindustan Pro to achieve an increase in its profitability from 28 per cent to 35 per cent. Alternatively, he wants the company to become the lowest cost producer of racing bikes in the whole of India by bringing down manufacturing cost per bike to Rs.3,000.

Environment Scanning

Firstly, you need to recommend a long-term objective which would require the collection of critical internal and external information. The internal information is readily available. The external information will require the expense of money. The company's strategy analyst has suggested the undertaking of Specialty Bicycle Consumer Study for India for its statistical significance and the Indian Bicycle Retailing Industry Analysis for its detail. Both these studies would help in trend analysis, statistical data and information specific to sports bicycle retailers. Both these studies were done at a stipulated budget of Rs.3,00,000.

Long-term Objective

Having assembled the information needed to decide the long-term objective, there are four long-term objectives under consideration (two each by the Chairman & the CEO). Based on the advice of company's strategy consultant, the following long-term objective has been selected "To become No.1 sports specialty bike in India in terms of revenues (target Rs.1500 crore)".

The objective selected seems to be the best suited to company's internal situation and external environment. The information derived from the earlier mentioned studies has helped in arriving at a decision. Still further information would have added value to the decision arrived.

SWOT Analysis

(i) Strengths of the company include cash position sale of the bike branded "Anti-Gravity" through dealers and service network.

(ii) Weaknesses of the company are: low presence in areas witnessing sharp growth, male-oriented brand image, low brand recall among 12-24 age group.

(iii) Opportunities identified include market for women consumers, extreme sports markets (juvenile bikes segment), increased focus on sports due to enhanced government spending, environment and health consciousness among younger population.

(iv) Threats are the low cost imports from China, saturation of market for male buyers, attraction of gen-next to cricket.

Matched Pair Analysis

Matched Pair Analysis can expand the scope of Conventional SWOT analysis by facilitating of more matches between SWO and T than the latter. Matching pairs from SWOT analysis enables the identification of optimum strategies.

Now undertake the following exercise :

- (i) Perform the conventional SWOT matches such as S/O, S/T, W/O, W/T
- (ii) Do the O/T and S/W matches.
- (iii) Also undertake S/O/T, O/S/W, T/S/W and SW/O/T matches.

On the basis of above mentioned strategic choices, you may identify the strategies that will enable Hindustan Pro to achieve its long-term objective of becoming No.1 specialty bicycle in the whole of India in terms of revenues in the next five years.

Outcome

The matched pair analysis discloses the strategic alternative of shifting focus from middle aged consumers to women consumers. The specific strategy should be to improve brand recall among women consumers, creating a range of bikes appealing to women consumers, increasing women sales staff and sell the "Anti Gravity" brand through other specialty bicycle retailers as well.

Source: *Crafting & Executing Strategy: Concepts & Cases. Thomson, Arthur A. et.al*

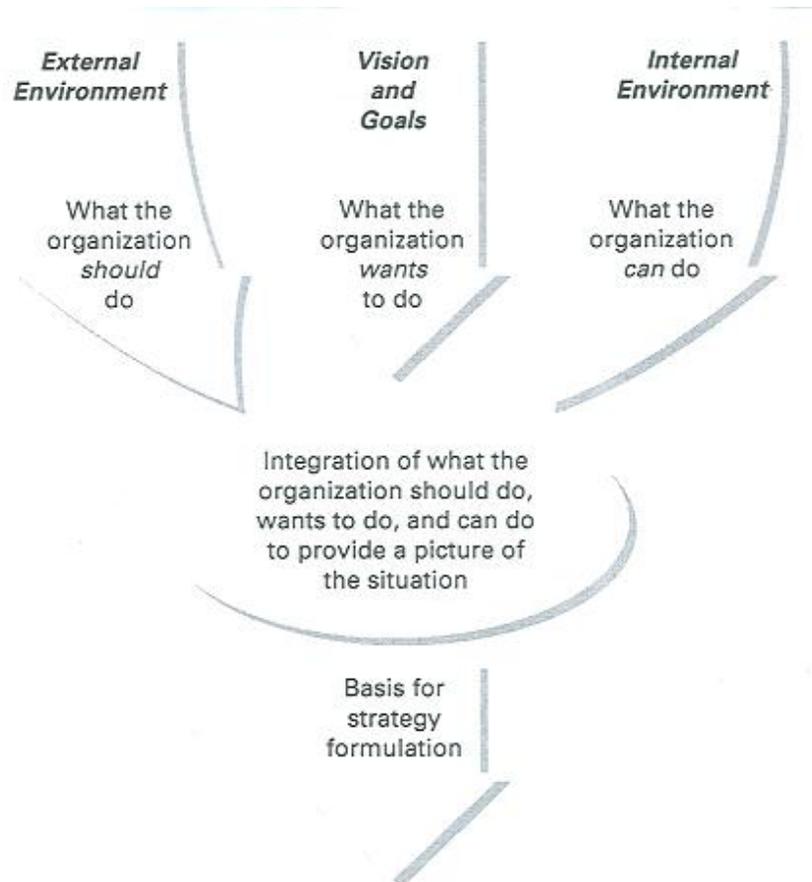
SITUATIONAL ANALYSIS

Situational analysis is an exercise which involves great deal of gathering, classifying, analysis and understanding of information. This consists of three separate processes:

- (1) External environmental analysis;
- (2) Internal environmental analysis; and
- (3) The development of the organization's mission, vision, values, and goals.

The interaction and results of these processes form the basis for the development of strategy. These three interrelated processes drive the strategy.

A closer look at these three interrelated processes is presented in the following diagram.



Analysing and Understanding the Situation

These influences must be understood before a strategy may be formulated, as they represent the organization's situation. Forces in the external environment suggest "what the organization should do." That is, success is a matter of being

effective in the environment – doing the “right” thing. Strategy is additionally influenced by the internal resources, competencies, and capabilities of the organization and represents “what the organization can do.” Finally, strategy is driven by a common vision and set of common organizational values and goals. Vision, values, and goals are the result of considerable thought and analysis by top management and indicate “what the organization wants to do.” Together, these forces are the essential input to strategy formulation. The issues in the external environment directly and simultaneously affect all three situational analysis processes. Issues in the external environment will affect the process of environmental analysis; provide the context for internal analysis, and influence the mission, vision, values, and goals of the organization.

Illustration:

A regulatory change, such with its massive cuts in reimbursement for medicare, independently affected the interpretation of the external environment (seen as a new major threat), the determination of factors to be considered strengths or weaknesses of the organization (efficiency as a major new strength), and the way managers view the mission, vision, values, and goals (who the organization serves). Moreover, the three situational analysis processes affect one another. They are not completely distinct and separate; they overlap, interact with, and influence one another.

PEST ANALYSIS

Johnson and Scholes developed a technique known as PEST Analysis to indicate the importance of political, economic, social and technological influences on a business organization or a company.

 *PEST analysis stands for "Political, Economic, Social, and Technological Analysis" and describes a framework of macro environmental factors used in environmental scanning. It is a part of the external analysis when doing market research and gives a certain overview of the different macro environmental factors that the company has to take into consideration. It is a useful strategic tool for understanding market growth or decline, business position, potential and direction for operations.*

The PEST analysis has basically divided the general environment into the following major categories:

1. Political (including Legal): It relates to the pressures and opportunities brought by changes of the government and public attitudes towards the industry, changes in political institutions and the direction of political processes, legal issues, and the overall regulatory climate. Some of the important attributes in this category includes political stability, intellectual property invasion, risk of military invasion, legal framework for contract enforcement, tax policies, safety regulations, wage legislations, anti trust laws, pricing regulations, trade regulations and tariff etc.

2. Economic: It refers to a society's economic structures and such variables as the stock exchange, interest and inflation rates, economic growth rate, business cycle stage, stage of economic development, exchange rate and stability of host

country currency, comparative advantage of host country, Government intervention in the free market working, infrastructure quality, the nation's economic policies and performance, exchange rates, etc. These variables impact differently on different industries.

3. Social: It basically covers cultural attitudes, ethical beliefs, shared values, class structure, entrepreneurial spirit, level of differentiation in lifestyle, demographics, education levels, etc. Observing social factors helps the organizations to maintain their reputation among stakeholders.

4. Technological: It includes the changes in technology which can alter the firm's competitive position. Industries merge; new strategic groups emerge; current products improve and the cost of production gets reduced by process innovation. Managerial innovation is part of the technology scan. The categories can be further subdivided with time and geographic scope as variables.

The number of macro environmental factors is virtually unlimited. In practice, the firm must prioritize and monitor those factors that influence its industry. Even so, it may be difficult to forecast future trends with an acceptable level of accuracy. In this regard, the firm may turn to scenario planning techniques to deal with high levels of uncertainty in important macro environmental variables.

The PEST analysis consists of following five main steps:

1. Understand a category's relevant trends:

- Research the important variables of the organisation's strategy.
- Determine the long term trends that apply to these variables.
- Research the past behaviour of these variables.
- Analyse the predictability of the trend lines and their fluctuations.
- Assess the impact of these trends on the organization.

2. Understand trend interdependencies:

- Analyse which trends are interrelated.
- Determine which trends conflict by understanding movements in opposite directions.

3. Distill likely issues from the identified trends:

- Validate the impact of trends on the organization.
- Distill the most critical trends that have the greatest impact given the organisation's objectives.

4. Forecast the direction of issues:

- Determine the fundamental drivers behind a critical trend.
- Assess the behaviour of the critical trend.
- Run a sensitivity test to assess impact.

5. Derive implications for the organization:

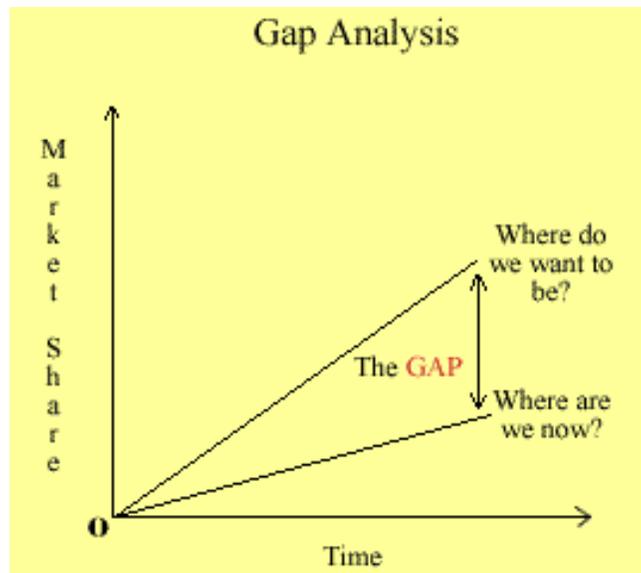
- Assess the affect of critical environmental changes on the industry.
- Assess affect of critical environmental changes on a firm's competitive position.
- Assess the affect of critical environmental changes on a direct

- competitor's position.
- Validate a firm's competitive nature.

The PEST Analysis may contribute to environmental analysis in three ways. First, it may enable identification of a smaller number of key environmental influences. Secondly, it may also be helpful in identifying long-term drivers of change in environment. Thirdly, it may help to examine the different impact of external influences on organization either historically or in terms of likely future impact.

GAP ANALYSIS

GAP analysis is the process of identifying the gap between the optimized allocation and integration of the inputs and the current level of allocation. This helps company provide insight into areas that have room for improvement. The gap analysis process involves determining, documenting and approving the variance between business requirements and current capabilities. Gap analysis naturally flows from benchmarking and other assessments. Once the general expectation of performance in the industry is understood, it is possible to compare that expectation with the level of performance at which the company currently functions. This comparison becomes the gap analysis.



Under Gap Analysis attention is first focused on the gaps between the actual or anticipated values that certain variables take on and the values that are most desirable. Once the gaps are properly identified, attention shifts to devising ways to close them. Gap analysis has been advocated for strategic choice decisions within the following four primary contexts: (1) Environmental analysis, (2) Functional-level policy analysis, (3) Business-level strategy analysis, and (4) Corporate-level strategy analysis.

Environmental GAP Analysis: For purposes of environmental analysis, gap analysis is a way of focusing on differences between the firm's strategy set and resources and the threats and opportunities that make up its environment. More

specifically, it is used to identify gaps between where a firm would be if it continued with its present strategy and was subjected to expected environmental developments, and where the strategist would like the firm to be in terms of strategic goals. Thus, this planning gap can be filled by implementing new action plans, or strategic goals can be altered.

Function Level GAP Analysis: A popular use for gap analysis is to compare actual and potential market variables for marketing strategy purposes. Webber proposes a form of gap analysis for analyzing the differences between industry market potential and the firm's own sales by product line. This overall gap is made up of the following four segments:

- (a) *Product-line gap* – the portion due to each product in the full product line.
- (b) *Distribution gap* – the portion caused by an inadequate distribution system.
- (c) *Usage gap* – the part caused by less than full usage.
- (d) *Competitive gap* – the segment caused by sales that are lost to direct competitors.

Each type of gap may be closed through its own set of strategic or tactical moves. They correspond to business-level goals and action plans or marketing strategy, depending upon the level of their organization. Accurately determining the type and magnitude of each kind of gap is the difficult part of market gap analysis. However, this technique focuses attention on defining the various elements of a firm's sales shortfall.

Business Level GAP Analysis: There are similarities between gap analysis at the business level, gap analysis for environmental analysis and functional-level analysis. At the business level, however, the gaps of interest are those related to the performance of the business unit as a whole. The focus is on gaps between actual and planned-for results according to such criteria as various profit measures, cash flow generation, management expertise, company image, and relative product quality. Consequently, the gap analysis at the business level is very much like analysis of budget variances.

Corporate Level GAP Analysis: When applied to the corporate level, gap analysis focuses on the consolidated performance of the portfolio of business units. Differences between desired values of performance variables (gross, operating, or net profit on total assets or equity; growth rate of sales; geographical coverage; and so on) and actual values can trigger portfolio modification decisions i.e., corporate-level strategic decisions.



GAP analysis is the process of identifying the gap between the optimized allocation and integration of the inputs and the current level of allocation. It involves determining, documenting and approving the variance between business requirements and current capabilities. In it attention is first focused on the gaps between the actual or anticipated values that certain variables take on and the values that are most desirable.

PLANNING OF GAP

The need for new products or additions to existing lines may have emerged from

the portfolio analysis. The need may have emerged from the regular process of following trends in the requirements of consumers. At some point a gap will have emerged between what the existing products offer the consumer and what the consumer demands. That gap has to be filled if the organization is to survive and grow.

To identify the gap in the market, the technique of gap analysis can be used. Thus, an examination of what profits are forecasted for the organization as a whole compared with where the organization (in particular its shareholders) wants those profits to be is called the planning gap. This shows what is needed for new activities in general and for new products in particular.

The planning gap may be divided into the following four elements:

(1) Usage Gap: This is the gap between the total potential for the market and the actual current usage by all the consumers in the market. Market Potential and Existing Usage figures are needed for this calculation.

Market Potential: The most difficult estimate to make is that of the total potential available to the whole market, including all segments covered by all competitive brands. It is often achieved by determining the maximum potential individual usage, and extrapolating this by the maximum number of potential consumers. This is inevitably a judgment rather than a scientific extrapolation, but some of the macro-forecasting techniques may assist in making this estimate more accurate.

The maximum number of consumers available will usually be determined by market research, but it may sometimes be calculated from demographic data or government statistics. Ultimately there will, of course, be limitations on the number of consumers. For guidance one can look to the number of consumers using the similar products. Alternatively, one can look to what has happened in other countries. The maximum potential individual usage, or at least the maximum attainable average usage, will usually be determined from market research figures. It is important, however, to consider what lies behind such usage.

Existing usage: The existing usage by consumers makes up the total current market, from which market shares, are calculated. It is usually derived from marketing research, most accurately from panel research. Sometimes, it may be available from figures collected by government departments or industry associations.

Thus, Usage gap = Market potential – Existing usage

In the public sector, where the service providers usually enjoy a monopoly, the usage gap will probably be the most important factor in the development of the activities. The usage gap is most important for the brand leaders. If any of these has a significant share of the whole market, say in excess of 30 percent, it may become worthwhile for the firm to invest in expanding the total market. The same option is not generally open to the minor players, although they may still be able to target profitably specific offerings as market extensions.

(2) Product Gap: The product gap, also known as the segment or positioning gap, represents that part of the market from which the individual organization is excluded because of product or service characteristics. This is because the market has been segmented and the organization does not have offerings in some segments, or it may be because the positioning of its offering effectively excludes it from certain groups of potential consumers, because there are competitive offerings

much better placed in relation to these consumers. The product gap is probably the main element of the planning process in which the organization can have a productive input; hence the emphasis is given on correct positioning.

(3) Competitive Gap: Competitive gap refers to the share of business achieved among similar products, sold in the same market segment, and with similar distribution patterns - or at least, in any comparison, after such effects have been discounted. Needless to say, it is not a factor in the case of the monopoly provision of services by the public sector. The competitive gap represents the effects of factors such as price and promotion, both the absolute level and the effectiveness of its messages

(4) Market Gap: In the type of analysis described above, gaps in the product range are looked for. Another perspective (essentially taking the 'product gap' to its logical conclusion) is to look for gaps in the 'market' in a variation on 'product positioning', and using the multi-dimensional 'mapping', which the company could profitably address, regardless of where it's current products stand.

Illustration:

Gap Analysis in Vodafone's finance functions

KPMG and Vodafone have used gap analysis to develop a global finance vision and strategy for Vodafone. The objective was to align Vodafone's 18 disparate and autonomous operating companies so as to transform the organization. The six core areas addressed by KPMG included a gap analysis of the present finance team structure and operational effectiveness with regard to the following :

- (i) Compared with global best practice
- (ii) Compared with the current and financial needs of Vodafone's new organizational structure
- (iii) A vision and strategy for finance
- (iv) A roadmap of pragmatic options for achieving the vision
- (v) A business case to justify the investment required to implement the recommended strategy.

Both KPMG and Vodafone worked together to ascertain existing position of Vodafone's global finance function to benchmark it against best practice and to develop a commonly agreed view of how the organization could develop an effective and pragmatic high level plan.

Four dimensions of the finance function were analyzed namely: (i) the finance organisation; (ii) decision support; (iii) transaction processing; and (iv) finance systems. The exercise involved all key stakeholders including internal customer and wider finance community to understand gaps in the current global finance function. Site visits were made of leading finance organizations to identify global best practice, uncover key strategies and ROI from finance transformation.

Consequent upon review of Vodafone's global finance function, a transformation program has been established with four key priorities:

- (i) world class transaction processing
- (ii) simplified business planning
- (iii) insightful management information
- (iv) induction of great people in finance.

The customer has been put at the centre stage of Vodafone's financial strategy. The exercise has thus filled-up the gaps in Vodafone's finance strategy.

IMPACT ANALYSIS

Impact analysis is a brainstorming technique which helps the users to think through the full impacts of a proposed change. As such, it is an essential part of the evaluation process for major decisions. More than this, it gives the ability to spot problems before they arise, so that companies can develop contingency plans to handle issues smoothly. This can make the difference between well-controlled and seemingly-effortless project management, and an implementation that is seen by boss, team and clients.

Impact analysis either takes the form of what if analysis or the sensitivity analysis. What-if analysis is a brainstorming approach that uses broad, loosely structured questioning to (1) postulate potential impacts that may result by changing a particular variable in a system or model and (2) ensure that appropriate safeguards can be taken if the proposed changes create a possible negative impact on the system. Sensitivity analysis is the study of how the variation in the output of a mathematical model can be apportioned, qualitatively or quantitatively, to different sources of variation in the input of a model.

Impact analysis identifies the existing requirements in the baseline and other pending requirement changes where conflict with the proposed change continuously happens.

Illustration:

Puma's Application of Impact Analysis :

Puma for instance has blended the strategy and impact analysis in devising its partnership and acquisitions strategies. The company is well respected and well recognized global sports lifestyle brand. The company's logo is a puma poised to pounce. The word "puma" is shared by a range of companies besides the global lifestyle brand. Puma represents "adaptable generalist species which is a capable stalk and ambush predator". The qualities of puma represent a company's competitive spirit and ability to transcend short hardships with small strategic actions. Puma has adopted integrated partnership and acquisition strategy to achieve sustainable growth without diminishing brand's equity. For instance, in 1955 Puma forged partnership with Alexander McQueen--a famous fashion designer known for juxtaposition between contrasting elements to expand its global market presence. Puma's acquisition of Tretorn in 2001 has helped extend the brand in recreational sports category. In 2008, Puma acquired majority stake in Hussein Chalayan to emphasize on more fashion forward ranges and to penetrate a market that is on the periphery of the core brand. The company has adapted itself to different capabilities for core and peripheral business opportunities to emerge as formidable competitor in global sports lifestyle category.

VALUE CHAIN ANALYSIS

A value chain can be described as the full range of activities which are required to bring a product or service from conception through the different phases of production to its delivery to final consumers. In the illustrative case study of value chain appended to this topic, the value chain in the fishery sector can be defined as “movement of the product (fish) from the landing centers to the final consumer taking into consideration the entire gamut of service providers at the various levels of the chain, the value addition done or the service done to the product before its consumption”.

Key Elements of Value Chain Analysis

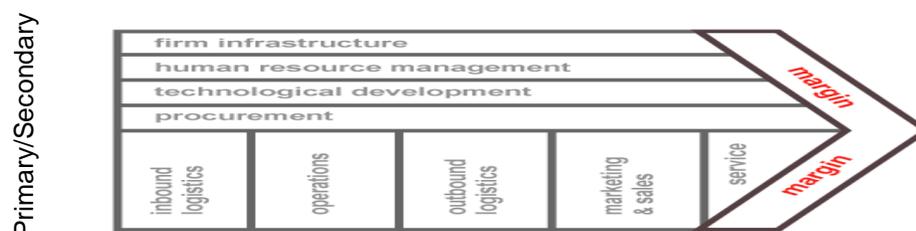
There are four elements in the value chain :

- (i) Design and Product Development
- (ii) Production
- (iii) Marketing
- (iv) Consumption/Recycling.

These elements describe the transition process undergone by a product/service before it is finally consumed. All the key elements can then be broken down into various sub-components and processes/sub processes.

Michael Porter in his famous book ‘Competitive Advantage’ introduced a generic value chain model that comprises a sequence of activities found to be common to a wide range of firms. Porter identified that the activities of a business could be grouped under two broad headings:

- (1) *Primary Activities* – It covers those activities which are directly concerned with creating and delivering a product (e.g. component assembly); and
- (2) *Support Activities* – It includes those activities which are not directly involved in production. It may increase effectiveness or efficiency. It is rare for a business to undertake all primary and support activities itself.



Primary Activities

Primary value chain activities include:

Primary Activity	Description
<i>Inbound logistics</i>	All those activities concerned with receiving and storing externally sourced materials.
<i>Operations</i>	The manufacture of products and services - the way in which resource inputs are converted to outputs.
<i>Outbound logistics</i>	All those activities associated with getting finished goods and services to buyers.
<i>Marketing and sales</i>	Essentially an information activity - informing buyers and consumers about products and services (benefits, use, price etc.)
<i>Service</i>	All those activities associated with maintaining product performance after the product has been sold.

Support Activities

Support activities include:

Secondary Activity	Description
<i>Procurement</i>	This concerns how resources are acquired for a business (e.g. sourcing and negotiating with materials suppliers). Those activities concerned with recruiting, developing, motivating and rewarding the workforce of a business.
<i>Technology Development</i>	Activities concerned with managing information processing and the development and protection of knowledge in a business.
<i>Human Resource Management</i>	Those activities concerned with recruiting, developing motivating and rewarding the workforce of a business.
<i>Firm Infrastructure</i>	Concerned with a wide range of support systems and functions such as finance, planning, quality control and general senior management.

The goal of these activities is to offer the customer a level of value that exceeds the cost of the activities, thereby resulting in a profit margin. The firm's profit then depends on its effectiveness in performing these activities efficiently, so that the amount that the customer is willing to pay for the product exceeds the cost of the activities in the value chain. It is in these activities that a firm has the opportunity to generate superior value. A competitive advantage may be achieved by reconfiguring the value chain to provide lower cost or better differentiation.

The value chain model is a useful analysis tool for defining a firm's core competencies and the activities in which it can pursue a competitive advantage as under:

- (i) Cost advantage by better understanding costs and squeezing them out of the value-adding activities; and
- (ii) Differentiation by focusing on those activities associated with core competencies and capabilities in order to perform them better than the competitors.

Cost advantage and value chain

A firm may create a cost advantage either by reducing the cost of individual value chain activities or by reconfiguring the value chain. Once the value chain is defined, a cost analysis can be performed by assigning costs to the value chain activities. The costs obtained from the accounting report may need to be modified in order to allocate them properly to the value creating activities. The following cost drivers related to value chain activities are:

- Economies of scale
- Learning
- Capacity utilization
- Linkages among activities
- Interrelationships among business units
- Degree of vertical integration
- Timing of market entry
- Firm's policy of cost or differentiation
- Geographic location
- Institutional factors (regulation, union activity, taxes, etc.)

A firm develops a cost advantage by controlling these drivers better than the competitors. A cost advantage also can be pursued by reconfiguring the value chain. Reconfiguration means structural changes such as new production process, new distribution channels, or a different sales approach.

Differentiation and Value Chain

A differentiation advantage can arise from any part of the value chain. For example, procurement of inputs that are unique and not widely available to competitors can create differentiation, as distribution channels that offer high service levels. A differentiation advantage may be achieved either by changing individual value chain activities to increase uniqueness in the final product or by reconfiguring the value chain.

The drivers of uniqueness identified are as follows:

- Policies and decisions
- Linkages among activities
- Timing
- Location
- Interrelationships
- Learning
- Integration
- Scale (e.g. better service as a result of large scale)
- Institutional factors.

Many of these above also serve as cost drivers. Differentiation often results in greater costs, resulting in trade-offs between cost and differentiation. There are several ways in which a firm can reconfigure its value chain in order to create

uniqueness. It can forward integrate in order to perform functions that once were performed by its customers. It can backward integrate in order to have more control over its inputs. It may implement new process technologies or utilize new distribution channels. Ultimately, the firm may need to be creative in order to develop a novel value chain configuration that increases product differentiation.

Technology and value chain

Technology is employed to some degree in every value creating activity and any changes in technology can impact competitive advantage by incrementally changing the activities themselves or by making possible new configurations of the value chain.

Various technologies are used in both primary value activities and support activities:

- **Inbound Logistics Technologies**
 - Transportation
 - Material handling
 - Material storage
 - Communications
 - Testing
 - Information systems
- **Operations Technologies**
 - Process
 - Machine tools
 - Material handling
 - Packaging
 - Maintenance
 - Testing
 - Building design and operation
 - Information systems
- **Outbound Logistics Technologies**
 - Transportation
 - Material handling
 - Packaging
 - Communications
 - Information systems
- **Marketing and Sales Technologies**
 - Media
 - Audio/video
 - Communications
 - Information systems

- **Service Technologies**

- Testing
- Communications
- Information systems

Many of these technologies are used across the value chain. Information systems are seen in every activity. Similarly technologies also are used in support activities. In addition, technologies related to training, computer-aided design, and software development etc., are frequently employed in support activities. To the extent that these technologies affect cost drivers or uniqueness, they can lead to a competitive advantage.

Linkages between value chain activities

Value chain activities are not isolated from one another. Rather, one value chain activity often affects the cost or performance of other ones. Linkages may exist between primary activities and also between primary and support activities. Consider the case in which the design of a product is changed in order to reduce manufacturing costs. Suppose inadvertently the new product design results in increased service costs, the cost reduction could be less than anticipated and even worse, there could be a net cost increase. Sometimes, the firm may be able to reduce cost in one activity and consequently enjoy a cost reduction in another, such as when a design change simultaneously reduces manufacturing costs and improves reliability so that the service costs also are reduced. Through such improvements the firm has the potential to develop a competitive advantage.

Interrelationships among business units form the basis for a horizontal strategy. Such business unit interrelationships can be identified by a value chain analysis. Tangible interrelationships offer direct opportunities to create a synergy among business units. For example, if multiple business units require a particular raw material, the procurement of that material can be shared among the business units. This sharing of the procurement activity can result in cost reduction. Such interrelationships may exist simultaneously in multiple value chain activities. However, attempts to achieve synergy from the interrelationships among different business units often fall short of expectations due to unanticipated drawbacks. The cost of coordination, the cost of reduced flexibility, and organizational problems should be analyzed when devising a strategy to reap the benefits of the synergies.

Outsourcing value chain activities

Value chain analysis is one way of identifying which activities are best undertaken by a business and which are best provided by others, say, outsourcing. A firm may specialize in one or more value chain activities and outsource the rest. The extent to which a firm performs upstream and downstream activities is described by its degree of vertical integration. A thorough value chain analysis can illuminate the business system to facilitate outsourcing decisions. To decide which activities to outsource, managers must understand the firm's strengths and weaknesses in each activity, both in terms of cost and ability to differentiate. Managers may consider the following when selecting activities to outsource:

- Whether the activity can be performed cheaper or better by suppliers.

- Whether the activity is one of the firm's core competencies from this stems a cost advantage or product differentiation.
- The risk of performing the activity in-house. If the activity relies on fast-changing technology or the product is sold in a rapidly-changing market, it may be advantageous to outsource the activity in order to maintain flexibility and to avoid the risk of investing in specialized assets.
- Whether the outsourcing of an activity can result in business process improvements such as reduced lead time, higher flexibility, reduced inventory, etc.

Value chain system

A firm's value chain is a part of a larger system that includes the value chain of upstream suppliers and downstream channels and customers. Porter specifies this series of value chain system as under:



Value Chain System

Linkages exist not only in a firm's value chain, but also between value chains. While a firm exhibiting a high degree of vertical integration is poised to better coordinate upstream and downstream activities, a firm having a lesser degree of vertical integration nevertheless can forge agreements with suppliers and channel partners to achieve better coordination. For example, an auto manufacturer may have its suppliers set up facilities in close proximity in order to minimize transport costs and reduce parts inventories. Clearly, a firm's success in developing and sustaining a competitive advantage depends not only on its own value chain, but on its ability to manage the value system of which it is a part.

Following are the sequential steps in a value chain analysis:

- (1) Segregate a market/organisation into its key activities under each of the major headings in the model;
- (2) Assess the potential for adding value via cost advantage or differentiation, or identify current activities where a business appears to be at a competitive disadvantage;
- (3) Determine strategies built around focusing on activities where competitive advantage can be sustained.

What activities a business undertakes is directly linked to achieving competitive advantage. For example, a business which wishes to outperform its competitors through differentiating itself through higher quality will have to perform its value chain activities better than its opponents. By contrast, a strategy based on seeking cost leadership will require a reduction in the costs associated with the value chain activities, or a reduction in the total amount of resources used.

Illustration:**OXFAM INDIA'S VALUE CHAIN ANALYSIS OF FISHERY IN PURI AND GANJAM DISTRICTS OF ORISSA**

Oxfam India in its study of "Value Chain Analysis of Fishery in Puri and Ganjam District of Orissa" has aimed at capturing the essence of the processes and flow of value chain in fishery. The study has identified the role and importance, cost of operation, barriers to entry, mobility and exit, economies of scale, effect of market forces etc. so as to map the key processes and flows in the value chain of fishery in respect of local, regional and international market. Ganjam and Puri have 26 and 85 fishing villages with a total fish catch of 14053, 22 MT & 25000 MT (Directorate of Fishery, Puri and Ganjam 2003-04). Coastal fishing is done within 5 kms from the coastline with the help of catamarans and country boats. Ocean fishing on deep sea fishing involves fishing beyond 5 kms of the coastline. It is done with the help of trawlers, Beach Landing Crafts (BLC) and Fibre Reinforced Plastic Boats (FRPs). Freshwater fishing, Brackish water fishing and fish culture are the methods employed by fishers. The fishing net costing between one lakh rupees to Rs.1.50 lakh is a major investment and a net lasts for about 5-7 years.

Market Segmentation

Local markets for fishing are small with limited number of sellers. These markets have a demand for low value product due to low purchasing power of the concerned consumers.

The Regional markets are bigger and situated in state capitals, large cities with variegated supply-demand linkages. The volume of trade is high but cost of operation is equally higher due to logistical factors.

Export market is quality conscious using only high value product. The cost of operations is very high along with erratic behaviour of demand and price. The export markets are in Japan, UAE, USA, European Union, China and Middle East.

Product Segmentation

Based on affinity and nature, the products are clubbed together in four value slabs namely: (i) Export value product; (ii) High value product; (iii) Average value product; and (iv) Low value product.

The export value product fetches a high premium. The products undergo value chain with very low cost of operation and high profit margin. The processing plants have to conform to FDA, EU and ISO norms for supply to different markets. The value chain is more organized due to the influence of global market marked by very high competition.

The high value products are consumed in the domestic market and command a good price. The collection point is the middleman followed by agents and wholesaler at regional market who then feed the retail distribution channel. The product of this

segment undergoes minimal processing. The Kolkata and Chennai are the leading markets that govern the prices of this segment based on daily market demand.

The average value product is consumed locally with a certain percentage being moved to the regional market. Kolkata regional market predominates in the matter of governance of prices. The products also meet the industrial requirements for poultry feed etc. The profit margin in this segment is on the lower side.

Low value product caters to small fishers of very low economic value and dominated by local players i.e., the fishers. Direct buyers and retail agents are the main players on this segment. The supply chain begins at landing centre and ends-up with final consumers/retailers.

BCG-Matrix

It provides a framework for allocation of resources among different business units:

Cash Cows: In the fishery industry, these are the high value products meant for domestic markets and which yield a constant profit over a period. They indicate a stable product with established value chain, low investment and stable returns.

Stars: These are the export value products with exemplary profits. There is vast unexplored potential which can yield high annual turnover. It needs more investment to realize the full potential.

Question Mark: These are the products with no properly defined market. Since the potential of these products has not been defined and explored, they can be turned into stars with proper investment and marketing intelligence. These products are traded at decent margins of profits.

Dogs: These represent low value products like small crabs or small fish which command low demand, low profits and a limited growth potential. The value chain of this product is degenerate chain with negligible number of operators.

On the whole, the maximum products belong to the "Dog Category" followed by stable products enjoying stable market as well as margins. "Question marks" comprise high number of products which have the potential to move to the star category or alternatively degenerate to become dogs. The "Stars" have very limited product lines that yield high level of profits.

Fishery Value Chain

Value chain in fishery is different for the product segments and the market segments. The product can be related to the type of fishery gears and in turn the size of the operations. The coastal species are different from deep sea species. The volume of catch is different depending on the type of fishing gears. Accordingly, there could be three types of supply chain i.e., traditional boat owners, motorized boat owners and trawler owners. The traditional boat owners can have smaller catch. Compared to craft owners, they can catch few high value species. Since they catch low value product, it is destined to local markets. The catches of motorized craft owners are

high value products with high demand in the regional market. The major catch of “trawler owners” are the fishes found in deep sea. The product falling in the low category of value catch is the one which is dried on board. The high value products are channeled to the regional and international markets.

Besides the above, there are a number of players in the chain ranging from auction agents, transporters, ice providers, godown owners, wholesalers, exporters, loaders, cycle venders, fish packers and ancillary participants. The value chain in fishery comprises on the whole a disparate set of five players namely : (i) producers (fishers); (ii) middlemen (consortium of traders) who are united; (iii) wholesalers; (iv) exporters marked by internal interse’ competition and (v) the other players like local traders.

Characteristic of Fishery Value Chain

1. The value chain in fishery is critically limited in terms of poor communication and infrastructure which leads to inefficient usage of resources. The other set of problems arises due to unique characteristics of fresh aquatic products like uncertain production, putrescibility and transportation problems. The present distribution channel is therefore incompetent.

2. Two Phase Value Chain

Fishery value chain is composed of two different phases. These are : (i) Primary phase of catch/culture and (ii) Secondary Industrial phase. Coupled with a range of support services like transportation, commercialization these form a complex of “production-distribution-consumption cycle”. Due to practical constraints, the articulation between the primary and secondary phases continues to be weak despite some efforts at linkage developing. The problem connected with the method of catch is of prime concern to the industrial phase because of barriers to trade created by global market standards which limits the possibilities for industrial processing.

Limitations of Fishery Value Chain

- ▶ The causes of poor livelihood of fishermen arise from exploitation by the supply chain (i.e., middlemen), lack of information, poor infrastructure, outdated technology, low pricing, social factors and government policies.
- ▶ Value chain is limited in terms of number of markets and spread of the product in terms of geographical locations.
- ▶ The market intelligence is limited to the middleman which is not passed on to the players lower in the value chain. It impedes the profitability of the operation.

Source: *Crafting & Executing Strategy: Concepts & Cases. Thomson, Arthur A et.al*

BUSINESS PROCESS RE-ENGINEERING (BPR)

Business process re-engineering (BPR) is a management approach aimed at improvements by means of elevating efficiency and effectiveness of the processes which exist within and across organizations. The key to business process re-engineering organizations is to look at their business processes from a clean perspective and determine how they can best construct these processes to improve the conduct of their business. Business process re-engineering can be defined as the analysis and design of workflows and processes within and between organizations. It is basically the critical analysis and radical redesign of existing business processes to achieve breakthrough improvements in performance measures. Business process re-engineering is also known as business process redesign, business transformation or business process change methodology. It is fundamental reconsideration and the radical redesign of organizational process, in order to achieve drastic improvement of current performance in cost, services and speed.

Instead of organizing a firm into functional specialties (like production, accounting, marketing, etc.) and to look at the tasks that each function performs, it is recommended to look at complete processes from materials acquisition, towards production, marketing and distribution. One should rebuild the firm and it should be rebuilt into a series of processes. Value creation for the customer is the leading factor for business process re-engineering and information technology often plays an important enabling role.

Business process is a set of logically related tasks performed to achieve a defined business outcome. It is a structured, measured set of activities designed to produce a specified output for a particular customer or market. It implies a strong emphasis on how work is done within an organization. Business processes have two important characteristics: (i) They have customers internal and external, and (ii) They cross organizational boundaries, i.e., they occur across or between organizational sub-units. One technique for identifying business processes in an organization is the value chain method.

Processes are generally identified in terms of beginning and end points, interfaces, and organization units involved, particularly the customer unit. Examples of process include: developing a new product; ordering goods from a supplier; creating a marketing plan; processing and paying an insurance claim; etc., are example of business process.



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Objectives of Business Process Re-engineering

The basic objectives of business process re-engineering in an organization include the following:

(i) Elimination of Redundant Processes: It is generally observed that with the growth of an organization over a period of time, number of processes are added without deleting the old one, in order to get the organization working. This leads the organization to become process oriented rather than result oriented. Although this pays rich dividend due to absence of meaningful competition but it starts showing weakness as the competition increases. Thus, to make the organization result oriented, the processes which are irrelevant must be eliminated.

(ii) Reduction in Cycle Time: Business process re-engineering also aim to reduce the cycle timing of processing for completing the job. It is possible by reducing the number of steps involved in processes.

Overall business process re-engineering, with the help of elimination of redundant processes and reduction in cycle time, enables the organization to increase the degree of competitive advantage.

Steps for Business Process Re-engineering

Following steps are considered for business process re-engineering:

- (i) Developing business vision and process objective:** Under this process it is desirable that a vision of organization is defined clearly so that one can put business process function in tune with the vision. Basically organizational vision depicts the challenging position what the organization will be in future. BPR is driven by a business vision which implies specific business objectives such as cost reduction, time reduction, output, quality improvement etc. Accordingly, organization should make projections about where it should go and what are the major challenges ahead. Thus, in the light of business vision, organization should define the objective of business processes.
- (ii) Identifying the process to be redesigned:** Once business vision and process objectives are clearly defined, the organization should focus and identify those processes which needs redesigning.
- (iii) Measuring the performances of existing processes:** Under this step, the organisation should focus on various methods used to measure the performance of a process to determine whether an opportunity exists to improve its efficiency, effectiveness and adaptability. Two popular methods include benchmarking and process evaluation.
- (iv) Identification of the opportunity for application of information technology:** Under this step, the emphasis is placed on application of IT knowledge to support a process and redesign the process accordingly. As against this, under the conventional approach method of process design, firstly it establishes a process and than assesses the information requirement.
- (v) Building prototype of new processes:** Under this step, the organization should design a new process on an experimental basis in the light of series of revision and improvement until the redesign process is put in actual operation. The prototype must be tested to measure this performance and incorporate needed changes. It may be noted that the testing should be in realistic environment as far as possible.

Principles of Business Process Re-engineering

Re-engineering strives to break away from the old rules and procedures that develop and become ingrained in every organization over the years. These may be a combination of policies, rules and procedures that have never been seriously questioned because they were established years earlier. These rules of organization and work design were based on assumptions about technology, people, and organizational goals that may no longer be relevant. Rather than attempting to fix existing problems through minor adjustments and fine-tuning existing processes, the key to re-engineering is to ask "If this were a new company, how would we run this place?"

The following principles are suggested for re-engineering:



- *Organise around outcomes, not tasks: Design a person's or a department's job around an objective or outcome instead of a single task or series of tasks.*
- *Capture information once and at the source: Instead of having each unit develop its own database and information processing activities, the information can be put on a network so that all can access it.*
- *With computer-based information systems, processes can now be re-engineered so that the people who need the result of the process can do it themselves.*
- *People or departments that produce information can also process it for use instead of just sending raw data to others in the organization to interpret.*
- *With modern information systems, companies can provide flexible service locally while keeping the actual resources in a centralized location for coordination purposes.*
- *Instead of having separate units perform different activities that must eventually come together, have them communicate while they work so that they can do the integrating.*
- *Put the decision point where the work is performed and build control into the process: The people who do the work should make the decisions and be self-controlling.*

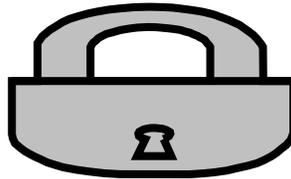
LESSON ROUND UP



- Learning about a firm's external environment is an important component of strategic management process. A firm's environment consists of its macro environment and the industry in which it operates. With the help of environmental scanning firms identifies the opportunities and threats.
- The macro environment has five segments: economic, technological, political-legal, socio-cultural and global environmental dimensions. In the analysis of external environment the firm determines the strategic relevance of environmental change and trends for each segment. Environmental scanning not only means scanning of current position of different components within each relevant section but also forecasting the future state and its impact on the firm.
- After making an analysis of macro environment the strategist undertakes an analysis of the industry in which the firm operates because it has a more direct effect on the firm's strategic actions. The five forces model of competition includes the threat of entry, the power of suppliers, the power of buyer, product substitutes, and the intensity of the rivalry among competitors. By studying these forces, the firm finds a position in an industry where it can influence the forces in its favor or where it can buffer itself from the power of the forces in order to increase its ability to earn above average returns.
- Every industry consists of different strategic groups. A strategic group is a collection of firms that follow similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than it is between strategic groups.
- After gathering information about different macro environmental dimensions and industry forces the manager to synthesis this information to have a clear view of the opportunities and threats.
- An exhaustive scanning of the external environment in general and the industry in which the firm operates specifically, strategic planning requires an in-depth analysis of internal scanning of the firm to find its own strengths and weaknesses.
- Internal analysis in general involves two stages. First stage involves conducting a financial analysis with the help of financial ratios measuring different financial dimensions such as liquidity, coverage, profitability, leverage and activity. Second stage involves identifying the core competencies of the firm in general and strengths and weaknesses in each of the functional areas.
- In strategic management, a strategist uses different tools and techniques such as SWOT analysis, situational analysis, PEST analysis, gap analysis, impact analysis, value chain analysis, business process re-engineering etc.
- SWOT analysis is conducted to identify the strengths, weaknesses, opportunities and threat for a firm. Any firm needs to know about its strengths and weaknesses to meet the opportunities and threats presented by the external environment. So, every strategist needs to do a SWOT analysis before strategy formulation and implementation.

- Situational analysis is an exercise which involves great deal of gathering, classifying, analysis and understanding of information.
- PEST analysis is a useful strategic tool which helps to understand market growth and decline, business position, potential and direction for operation.
- Gap analysis enables a company to compare its actual performance with its potential performance or with the performance of the best performer in the industry. Gap analysis involves identifying the gap and then making all efforts to fill the gap.
- Impact analysis is a technique that helps the strategist to find the impact of a proposed change. It may be in the form of what if analysis or the sensitivity analysis.
- Value chain analysis is used to identify and evaluate the competitive potential of resources and capabilities. By studying their skills relative to those associated with primary and support activities, firms can understand their cost structure and identify the activities through which they can create value.
- Business Process Re-engineering (BPR) is a management approach aiming at improvements by means of elevating efficiency and effectiveness of the processes that exist within and across organizations.

SELF TEST QUESTIONS



1. What do you understand by business environment? Is it, normally, under the control of a business organization? Does it relate to internal strengths and weaknesses of a particular organization?
2. Explain the relevance of environmental scanning to strategic planning.
3. "The state of economy at present and in the future can affect the fortunes and strategy of the firm." Mention some of the economic determinants and show how these can help or hinder achievement of a firm's objectives.
4. Explain the role of Government as a helper, protector, financier and regulator of business and thus affecting the prospects of a business by providing opportunities and threats.
5. Explain various barriers to entry in an industry and also various barriers to exit from the industry. How do these affect competition in an industry?
6. Explain the conditions under which competitive rivalry increases.
7. Many firms now operate in what has been termed as the "global village". Why should they scan international environment, in addition to other factors that firms operating within their national boundaries scan, and, if so why?

8. What is the role of internal analysis in strategic management? Whether we should consider present position only or the most probable future conditions also?
 9. Explain the ways that firms can use to develop strengths by using information technology to gain competitive advantage.
 10. "Weaknesses must be compared with strength for internal analysis." Explain.
 11. Explain how a 'gap analysis' guides the choice of an appropriate strategy?
 12. What do you understand by 'business process re-engineering'?
 13. Write short notes on:
 - (i) PEST analysis
 - (ii) Situational analysis
 14. Why do you think value chain analysis has become a preferred approach to guide internal analysis? What are its strengths and weaknesses?
-

STUDY III
PLANNING AND FORMULATION

LEARNING OBJECTIVES



The object of this study lesson is to enable the students to:

- Understand the concept of vision and mission in strategic management
- Explain the meaning and significance of goals and objectives
- Develop different alternative strategies
- Specify the offensive and defensive strategies
- Understand the techniques of focus strategy, integration strategies, and diversification strategies
- Differentiate between internal diversification and external diversification
- Evaluate strategic alternatives
- Explain BCG Matrix, GE Matrix, Life Cycle Theory etc.
- Select best alternative strategy
- Understand and differentiate strategic planning, operational planning and tactical planning
- Understand the procedure of strategic decision making.

INTRODUCTION

Setting of organizational objectives is the starting point of the strategic management. Since organizations are deliberate and purposive creations, they have some objectives, the end results for which they strive. These end results are referred to as 'mission', 'purpose', 'objective', 'goal', 'target', etc. Many times, these terms are used inter-changeably as all these denote end results. However, there are differences in the context in which these terms are used. These end results are generally arranged in a hierarchical fashion. On the one hand, there may be enduring reasons why an organization exists and on the other hand, there may be specific results that an individual in the organization achieves in a specified period. Therefore, the end results have to be specified by different terms in different situation.

From planning point of view, an organization must define why it exists, how it justifies its existence, and when it justifies the reasons for its existence. The answers to these questions lie in the organization's vision, mission, objectives and goals.

VISION

It is especially important for any organization to agree on the basic vision that the organization strives to achieve in the long run. A vision statement should answer the basic question, ***“What do we want to become?”*** It concentrates on future; it is a source of inspiration and it provides clear decision-making criteria. Vision, is a realistic credible and attractive future of an organization. Vision basically refers to mental perception of the kind of environment that an organization aspires to create with a broad time frame. A vision relates to an organizations broadest and most desirable goal. A vision should describe a set-of ideals and priorities, a picture of the future, a sense of what makes the company special and unique, a core set of principles that the company stands for and a broad set of compelling criteria that will help define organizational success.

Illustration:

Dhirubhai Ambani had set the vision of making Reliance Industries the biggest private sector company in India.

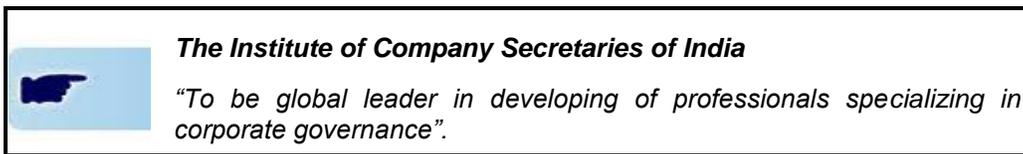
A clear vision provides the foundation for developing a comprehensive mission statement. Many organizations have both a vision and a mission statement, but the vision statement should be established first. The vision statement should be short, preferably in one sentence.

Features of an effective vision statement may include the following:

- Clarity and lack of ambiguity.
- Indicator of philosophy of organization.
- Provides the guiding principles to the organization.
- Well articulated and easily understandable.
- Profiles the future and constitutes what the organization wants to do.
- Memorable and engaging expression.
- Realistic achievable aspirations.
- Alignment with organizational values and culture.
- Time bound if it talks of achieving any goal or objective.

To become really effective, an organizational vision statement must become assimilated into the organization's culture. Leaders have the responsibility of communicating the vision regularly, creating narratives that illustrate the vision, acting as role-models by embodying the vision, creating short-term objectives, and encouraging others to craft their own personal vision compatible with the organization's overall vision.

Several examples of vision statements are given below for reference:



Tata Motors Ltd.

To be a world class corporate constantly furthering the interest of all its stakeholders.

Thomas Cook (India) Ltd.

"To become No.1 company in all our core business through customer focus and team work".

MISSION

Mission is a general statement of what distinguish the organization from all other of its types.

It should address the basic purpose of the firm, the reasons for which it exists. Mission is the answer of basic question, "What is our business?" A clear mission statement is essential for effectively establishing objectives and formulating strategies. It is the guiding principle that drives the processes of goal and action plan formulation, a pervasive, although general, expression of the philosophical objectives of the enterprise. Mission should focus on long-range economic potentials, attitude toward customers, product and service quality, employee relations, and attitudes toward owners. It provides identity, continuity of purpose, and overall definition, and should convey the following categories of information.

- Precisely why the organization exists, its purpose, in terms of (a) its basic product or service, (b) its primary markets, and (c) its major production technology.
- The moral and ethical principles that will shape the philosophy and character of the organization.
- The ethical climate within the organization.

Mission is the essential purpose of the organization, concerning particularly why it is in existence, the nature of the business, and the customers it seeks to serve and satisfy. Thus, it reveals what an organization wants to be and whom it wants to serve. Carefully prepared statements of vision and mission are widely recognized by both practitioners and academicians as the starting point of strategic management.

An ideal mission statement should possess the following features:

- Mission should be clear, both in terms of intentions and words used.
- It should be feasible, neither too high to be unachievable, nor too low to demotivate the people for work.
- It should be precise but self-explanatory, neither too narrow so as to restrict the organization's activities, nor too broad to make itself meaningless.

- It should be distinctive, both in terms of the organization's contributions to the society and how these contributions can be made.

Thus, mission outlines the firm's identity and provides a guide for shaping strategies at all organizational levels.

The role played by mission in guiding the organization is an important one. Specifically it:

- Serves as a basis for consolidation around the organization's purpose.
- Provides impetus to and guidelines for resource allocation.
- Defines the internal atmosphere of the organization, its climate.
- Serves as a set of guidelines for the assignment of job responsibilities.
- Facilitates the design of key variables for a control system.

Although many managers tend to develop qualitative mission statements, they can be expressed as a set of quantitative goals stated in financial terms. As such they specify the major financial outcomes expected by owners and managers from operation of the organization. Examples include market share, market growth, cash flow, stock performance, and dividend payout.

Further it may be noted that the mission statement must be believable in the sense that the company's behavior should correspond to it over both the short and long-term strategies. In this way, it can serve as the foundation for the development of respect and pride in the firm by management, employees, owners, customers, suppliers, and others who interact with it. Broad-based acceptance of the values represented by mission can lead to three characteristics of firms that accomplish this acceptance:

- They stand for something—the way in which business is to be conducted is widely understood.
- From the top most levels of management down through the firm's organization structure to the lowest level of production jobs, the values are accepted by all employees.
- Employees feel good because of a sense of identity which distinguishes the firm from other firms.

Some examples of mission statements from the corporate world are given as under:

	<p><i>The Institute of Company Secretaries of India</i></p>
<p><i>To continuously develop high calibre professionals ensuring good corporate governance and effective management and to carry out proactive research and development activities for protection of interest of all stakeholders thus contributing to public good.</i></p>	

Mattel Inc.

Mattel makes a difference in the global community by effectively serving children in need. Partnering with charitable organizations dedicated to directly serving

children, Mattel creates joy through the Mattel Children's Foundation, product donations, grant making and the work of employee volunteers. We also enrich the lives of Mattel employees by identifying diverse volunteer opportunities and supporting their personal contributions through the matching gifts program.

Microsoft Corporation

At Microsoft, we work to help people and businesses throughout the world realize their full potential. This is our mission. Everything we do reflects this mission and the values that make it possible.

NIKE Inc

To bring inspiration and innovation to every athlete in the world.

The Walt Disney Company

The mission of The Walt Disney Company is to be one of the world's leading producers and providers of entertainment and information. Using our portfolio of brands to differentiate our content, services and consumer products, we seek to develop the most creative, innovative and profitable entertainment experiences and related products in the world.

Illustration:

Crafting Mission Statement by Starbuck's

Starbuck's is the largest coffeehouse company in the world. It is an international coffee house chain with its origin from Seattle, Washington. Starbuck's involves its executives in the crafting of its mission statement. Through its mission statement the company wants to convey a strong sense of organisation purpose besides articulating company's fundamental beliefs and guiding principles (shown in the exhibit) given below:

Exhibit:

Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles while we grow.

The following six guiding principles will help us measure the appropriateness of our decisions.

- ▶ Provide a great work environment and treat each other with respect and dignity
- ▶ Embrace diversity as an essential component in the way we do business
- ▶ Apply the highest standards of excellence to the purchasing, roasting and fresh delivery of the coffee
- ▶ Develop enthusiastically satisfied customers all of the time
- ▶ Contribute positively to our communities and our environment
- ▶ Recognise that profitability is essential to our future success.

The views of the employees was taken into consideration in finalizing the mission statement

After the adoption of the mission statement, the management of the company undertook a mission review so as to determine whether the company has been living upto its stated mission. Comment cards were given to the employees on which they could submit their concerns to the mission review team of the company.

Source: *Crafting & Executing Strategy: Concepts & Cases. Thomson, Arthur. A et. al*

VISION AND MISSION STATEMENTS

Many organizations develop both a mission and vision statement. The mission statement answers the question, "what is our business," whereas the vision statement answers the question "what do we want to become?"

Mission statement and vision statement are different from each other in terms of following purposes. A mission statement defines the organization's purpose and primary objectives. Its prime function is internal i.e., to define the key measure or measures of the organization's success and its prime audience is the leadership team and shareholders. As against this, vision statement also defines the organizations purpose, but it does so in terms of the organization's values rather than bottom line measures.

The vision statement communicates both the purpose and values of the organization. For employees, it gives direction about how they are expected to behave and inspires them to give their best. Shared with customers, it shapes customers' understanding of why they should work with the organization.

- (i) The vision is a forward looking exercise of what an organization wants to become in future, the mission states what the organisation is and why it exists.
- (ii) While vision places emphasis on visionary long-term concept of the organization with very high level of achievement, mission deals mostly with how the organization will interact with various stakeholders' products/ services it offers and the way these are offered.

GOALS AND OBJECTIVES

Mission statements are designed to make the organization's vision more concrete and real to its people. However, mission statements still do not provide the tangible goals or objectives that must be met to achieve an organization's broader purpose. Thus, goal and objectives are needed to provide series of a direct, measurable tasks that contribute to the organization mission. Goals and objectives are the results to be achieved within specific time period, unlike the mission statements that describe the firm's purpose more generally, goals and objective designate the time period in which certain action and results are to be achieved.



Goals and objectives are the end results which an organization strives for. Thus, goal and objective consists of a projected state of affairs which a person or a system intends to achieve. It is the desired end-point in some sort of assumed development. Objectives and goals are more precise than vision and mission.

A desire or an intention becomes a goal if and only if, it activates an action for achieving it. It is roughly similar to purpose or aim, the anticipated result which guides action, or end, which is an object, either a physical object or an abstract object, that has intrinsic value.

Objectives are aims, or purposes that organizations wish over varying periods of time. Objectives are the intended end result that an organization desires to achieve over varying periods of time. Because of time variation, objectives may be specified in different ways in which long-term objectives are supported by short-term objectives.

Goals are to be stated specifically and as quantitatively as possible while objectives may be stated in quantitative and qualitative terms. The emphasis in goals is on measurement process towards the achievement of objectives. Objectives are desired further positions or destinations stated in broad timeless statements.

These terms are used interchangeably meaning one and the same thing. However, goals describe in fairly general terms what the organization hopes to accomplish. But, the objectives define in more precise terms as to what will be accomplished in order to reach the goals.

The objectives and goals may differ from each other in the following dimensions:

- (1) Time: Objectives are timeless, enduring, and unending whereas goals are temporal, time-phased, and intended to be superseded by subsequent goals. Objectives relate to the ongoing activities of an organization, their achievement tends to be open-ended and not bound by time. The objective of survival and growth of a business organization is never completely attained because non-attainability is a possibility. A goal on the other hand is short-lived as it is time bound.
- (2) Specification: Objectives are stated in broad, general terms, dealing with matters of image, style and self-perception. These are aspirations to be worked in the future. Goals are very specific, stated in terms of a particular result that will be accomplished by a specific date. Goals are more specific and time bound.
- (3) Focus: Objectives are usually stated in terms of some relevant environment which is external to the organization. Goals on the other hand, are more internally focused and carry important implications about how resources of the organization are utilized or will be utilized in future. Objectives are more generalized statements like maintaining market leadership, striving continuously for technological superiority, etc., whereas a goal may imply a resource commitment requiring the organization to use those resources in order to achieve the desired outcomes.
- (4) Measurement: Both objectives and goals can be stated in terms, which are quantitatively measured, but the character of measurement is different. Generally quantitative objectives are set in relative terms. For example, Reliance Industries has put its objectives like this: to acquire top position among the Indian companies. This objective may not be achieved in one year, but it is timeless and externally focused, providing a continuing

challenge for the company. Quantitative goals are expressed in absolute terms; say 20% increase in sales. The achievement of this goal can be measured irrespective of environmental conditions and competitors' actions.

FEATURES OF OBJECTIVES

- (1) Each organization has some objectives as it is created basically to attain the same. Members/employees in the organization try to achieve these objectives.
- (2) Objectives may be broad or they may be specifically mentioned. They may pertain to a wide or narrow part of the organization. They may be set either for the long term or for the short term.



The basic objective of a business organization may be to earn profit. This may be quite a broad objective. In order to achieve this broad objective, some specific objective may be set, for example, amount of profit to be achieved in a particular period.

Thus, general objectives may be translated into operative objectives to provide definite action.

- (3) Objectives may be clearly defined and have to be interpreted by the behaviour of organizational members, particularly those at top level. However, clearly defined objectives provide clear direction for managerial action.
- (4) Objectives have hierarchy. At the top level, it may be broad organizational purpose which can be broken into specific objectives at the departmental level. From departmental objectives, units of the department may derive their own objectives. This is due to grouping of people into sections, departments, divisions, etc., in the organization. All of them try to achieve organizational objectives and each level may contribute to the fulfillment of tasks assigned to it. Thus, a hierarchy of objectives is established.
- (5) Organizational objectives have social sanction; organizations are created within the social norms. They must conform to the general needs of the society.
- (6) An organization may have multiple objectives which may be functional and interrelated. Sometimes, the objectives may be even incompatible. This happens because over a period of time, many interest groups exert their pressure on organizational objectives. There are trade off among objectives. The achievement of one may be at the cost of the other at one point of time, while at other time, both can be integrated.
- (7) Organizational objectives can be changed as new ones may replace old objectives. It is possible because organizations are free to set their objectives within the overall social norms. Since objectives are formulated keeping in view the environmental factors and internal conditions, any change in these may result into change in objectives. For example, the Red Cross which was originally formed to hold itself in readiness in the war or any calamity to help the people found itself underemployed after World

War I. So subsequently added another objective-that of preserving and improving public health.

OBJECTIVE SETTING

All organizations have a formal, clearly recognized and legally specified system or mechanism for setting the initial objectives or their changes. The top management determines the overall objectives, which the members of the organization unite to achieve. In large corporate organizations, the board of directors, governing board, executive committee may set the objectives and may formulate or change the objectives according to the needs. The objectives are set through a complicated process involving various individuals and groups within and outside the organization, and by reference to the values, which govern behaviour in general, and the specific behaviour of the relevant individuals and groups in particular. There are multiple factors which determine the organisational objectives such as value system of managers, particularly at the top level, organisational strengths and weaknesses, awareness by management and external environment. Thus, managers should take into account all these factors.

Organization identifies two types of objectives:

- (a) General Objectives
- (b) Specific Objectives.

General Objectives

Considering all these factors, management should set the general objectives. The general objectives are quite broad in nature and show the direction in which the organization will like to proceed. For example, the general objectives of the business organizations may be survival, growth, contribution to the need of the society, profit earning, etc. These objectives may not be mutually exclusive; rather these can be achieved simultaneously. It is the question of giving relative importance to these.

Specific Objectives

General objectives are too broad and sometimes intangible to be transformed into action. As such, within the framework of general objectives, managers determine the specific objectives, which their units will seek to attain. Most of these objectives tend to be of short range in character and have definite time limits within which the organization has to achieve them. The specific objectives may prescribe the manner in which the general objectives may be achieved. These objectives may be in the form of diversification of the firm, liquidation of unprofitable divisions, reorganization of the company, etc.

Illustration:

A company has defined its specific objectives as expansion of present range of product, higher sale targets, import substitution, reducing cost without affecting the quality of the product, and expanding range of markets etc.

These specific objectives must fulfill two criteria.

- (1) translation of general objectives into specific objectives which should be

tangible and meaningful.

- (2) short-term objectives should contribute to the long-term objectives. Further the time-bound objectives are set to make the achievement of long-term objectives more feasible.

Illustration:

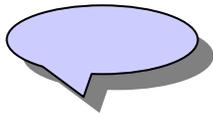
Long-term objectives involving plans for the distant future may fail to make individual objectives tangible and meaningful. This can be overcome by setting short-term objectives as different steps or stages of long-term objectives.

Corporate objectives may also be classified as internal and external objectives.

Internal objectives cover those objectives which defines how much is expected to be achieved with resources that the organization commands such as raising the average rate of return per annum on investment. External objectives on the other hand include those objectives which define the impact of the organization on its environment such as to develop high degree of customer confidence by sustaining high standard of excellence in product quality.

GUIDELINES FOR OBJECTIVE SETTING

An organization may consider the following guidelines for setting of objectives:



- *Objectives must be very clear and unambiguous.*
- *Objectives must be set taking into account the various factors influencing their achievement.*
- *Objectives should be consistent with organizational mission and vision statements.*
- *Objectives should be rational and realistic.*
- *Objectives should be achievable and must provide challenge to those responsible for achievement.*
- *Objectives should be result oriented.*
- *Objectives should be desirable for those who are responsible for the achievement.*
- *Objectives should be consistent with time period.*
- *Objectives should be periodically reviewed.*

DEVELOPING STRATEGIC ALTERNATIVES

An organization has to follow a strategy or a set of strategies to achieve its

vision, mission, goals, objectives, etc. A number of strategic options are available to an organization to achieve its multiple objectives. An organization may choose one or a set of strategies meeting its requirements. Although an organization may set the strategies which may be unique, the essential nature of it, sets the goals and action plans which tends to be one or some combination. Two organization could have the same strategic posture but they would be differentiated by their specific quantitative and qualitative goals, corporate- and business-level strategies, and functional strategies.

Broadly strategies may be divided into number of categories such as:

- offensive strategies,
- focus strategies,
- integration strategies,
- diversification strategies,
- defensive strategies, etc.

All these strategies are discussed below:

OFFENSIVE STRATEGIES

Offensive strategies are those strategies which are employed by management to reach goals related to increase in sales or market share, and in some cases, profitability. It should be pointed out that bringing about an increase in market share alone may not always satisfy performance expectations. There is some evidence suggesting that achieving high returns from high market share depends at least partly on some other considerations which are discussed as under:

(i) Concentration Postures or Strategies

Concentration postures are primarily the marketing moves attempted to improve sales or profitability by getting more out of resources currently available within the organization. There are some profound advantages to build a strategy around a firm's present products and market. The advantages are as under:

- (a) A concentration posture enables the organization to develop heightened expertise in its products and markets by specialization. Many organizations such as Holiday Inn, McDonald's and Xerox, etc., have dominated their industries by following concentration strategies.
- (b) By focusing on one segment of the market, or on one product or a limited product line, it helps the company to enhance its visibility. Chances are better for market leadership, especially when competitors have to spread their capabilities across multiple lines or segments.
- (c) The concentration increases operational flexibility by eliminating, or at least minimizing, interaction effects. Since multiple products in a line, or segments in a marketing mix, must compete for the organization's resources, non concentrated companies must balance resource allocation changes. Before more funds can be allocated to the marketing effort of one product, managers first may have to determine from which other products or

functions that fund will be diverted. Such decisions take time and thus tend to reduce the efficiency of decisions in non-concentrated firms relative to concentrated ones. As long as demand holds for the product or line, or in the market segments of a firm pursuing concentration, the potential for growth may be greater than for the other choices.

- (d) Industry dominance is gained by first concentrating on limited fields of technical know-how, product, or market; then reinforcing strengths like financial condition, experience, and share in these concentrated areas; until competitive superiority is achieved in the areas in which resource focus has been built. Once competitive advantage is established, management can apply its superior resources to achieve growth goals with far more dexterity.

(ii) Market Penetration

This posture is followed to increase sales within the organization's present markets with its present products. It is essentially an advertising action that would normally be followed by a market analysis undertaken to gain insight into user and non-user characteristics, as well as their perceptions of the product and its attributes. Obviously, such an analysis would have to reveal sufficient sales potential to justify the effort.

Functional actions may be designed to implement market penetration in terms of the following:

- (a) Increase present customers' through rates by product modification such as new improved, longer life, or more effective versions.
- (b) Explore new uses for the product, which will increase the sales.
- (c) Increase the number of customers within a segment by intensified advertising/promotion programs. This choice normally calls for improving advertisements, increasing media coverage or increasing advertising frequency, each of which would necessitate an increase in marketing budget, or at least a change in its application.

(iii) Market Development

Organizations with strategies aimed at market development seek to expand the geographical regions or the number of market segments they serve with their existing product. Some of the important strategies which may be followed for increasing sales through market development include the following:

- (a) Identification of new segments of the existing market area to which an appeal will be made, and then appropriately modify the advertising budgets and related strategies to develop a new series of advertisements.
- (b) Establishment of the necessary supply and distribution systems, along with promotion and advertising strategies, to take the product to a different geographical area; and
- (c) Development of new versions of the product to appeal to a new segment.

(iv) Product Development

Product development is a way to increase the sales in present segments by augmenting the present product line. Product development strategies can be operationalised by:

- (a) Developing new features for the existing products as often seen with various detergents, toothpastes, and cosmetics.
- (b) Designing additional models and sizes of the product such as different models of digital cameras by the same manufacturers.
- (c) Creating improved versions of products such as air conditioning systems, window and door installation units for the home etc.

(v) Horizontal merger

Horizontal merger is merging with or acquiring another company in the same industry. It is classified as a concentration posture because it involves increasing the firm's level of activity in its present products, markets, or both. However, such combinations carry the threat of allegations of anti-trust law violations.

(vi) Niching

A niche is a need in the market place that is currently unsatisfied. A niche market is a focussed targetable sub-set of a market. So business organization which focuses on a niche market addresses a need for product or service which is not being addressed by main stream providers. Thus, a niche market may be thought of a narrowly defined group of potential customers. Niche market ventures may become profitable even though they are by nature small in comparison to the mainstream market place due to the benefits of specialization and focus on identifiable small market segment even without benefit of economy of scale. Thus, niche marketing is the process of funding and serving profitable market segments and designing custom made product or services for them. For big companies, these market segments are often too small in order to serve them profitably as these market segments often lack economies of scale. A niche marketer relies often on the loyalty business model to maintain a profitable volume of sales.

Michael E. Porter defines lower cost and differentiation as bases of competitive advantage that, if successfully developed, can lead to strategies of cost leadership or cost focus and differentiation or focused differentiation, respectively, as shown below:

Competitive Scope

<i>Competitive Advantage</i>	<i>Broad Target Market</i>	<i>Narrow Target Market</i>
Lower Cost	Cost Leadership Action Plan	Cost Focus Action Plan
Differentiation	Differentiation Action Plan	Focused Differentiation Action Plan

Stated differently, organizations which have the competitive advantage of lower cost operations can formulate and implement action plans of cost leadership or cost focus. Businesses that have the competitive advantage of differentiated products can pursue action plans of differentiation or focused differentiation.

Lower Cost

With broad competitive scope (large mass market) the lower cost firm would strive for a cost leadership position by aggressively rationalizing its operations to maintain lower costs and concomitantly higher profit margins than its competitors.

Business organizations with lower cost advantages which are aiming at a narrow market definition, that is, a small niche, should embark upon a cost focus action plan. They might concentrate on a particular geographic area, well-defined group of customers, or a narrow set of demographics or needs while essentially abrogating the rest of the market to other competitors.

Lower cost strategies require making a product or service available more efficiently than one's competitors at the same quality level and doing it by functional rationalization. Rather than controlling costs only in production, rationalizing all functional departments so as to minimize the costs of their operation relative to competitors so that profit margins can be higher than those of competitors.

Some of the examples of functional actions which might be included to develop a lower cost strategy include the following:

1. Reduction in operating expenses in functional departments as well as corporate level operations in order to achieve superior relative cost position.
2. Thin product offerings to the best performers.
3. Reposition marketing efforts to the potentially most successful markets or segments.
4. Attempt to reduce cost of goods sold as a percentage of sales by streamlining inventory.

Low cost leadership carries their own set of advantages and disadvantages for the organisations which practice them. Some of the advantages available from low cost leadership strategies are based on the relatively large size of companies pursuing them.

The appeal of low cost leadership strategy is based on the strong relationship which appears to exist between high market share and high profitability. It has been revealed by various empirical studies that organizations with high market share for various reasons can command above average industry profitability over extended period. However, some of the empirical findings explain, at least partially, the relationship between high market share and profitability includes economies of scale, risk avoidance by customers, strong market presence and focused management.

Low cost organizations also have the unique advantage of being able to sustain price increases passed on their suppliers. Low cost organization can more easily absorb increases in the prices of components or ingredient used in their products just by operating at more cost efficient level.

Cost based strategies are not free from disadvantages. The biggest disadvantage is the high level of asset commitment and capital – intensive activities which often accompanies this strategy. It has been noted that in order to produce or deliver services at low cost, organizations often invest huge resources into rigid, inflexible assets and production or distribution technologies which are difficult to switch to other products and uses. Another disadvantage facing low cost organizations is that cost reduction methods are easily copied by others.

Differentiation

Differentiation strategies aim at providing buyer with something which is different and unique and makes the company's product or service distinct from that of its rivals. The basic assumption behind a differentiation strategy is that customers are willing to pay a higher price for a product which is distinct in some important way. Superior value is created because the product is of higher quality and technically superior in some respects.

Organizations use various ways such as innovative design, advanced materials, quality processes to differentiate their product from their rivals. In almost all differentiation strategies, attention to product quality and service represents the dominant route for the organization to build competitive organization.

Business organization with the competitive advantage of a differentiated product or service can formulate and implement action plans to differentiate within a broad market or to focus differentiation in a narrow market. Differentiation is striving for industry-wide uniqueness whereas focused differentiation aims at a concentrated market definition. The premier example of broad-based differentiation is Mercedes-Benz' quality-based franchise in the worldwide automobile market.

Differentiation strategies when carried out successfully reduce buyers' price sensitivity, increase their loyalty and reduces the extent to which they search for attractive products.

A big disadvantage associated with differentiation is that organization which may attempt to "out differentiate" organisation which already have distinct products by providing a similar or better products. Hence, differentiation strategies although effective in generating customers' loyalty and higher prices, do not completely seal off the market from the entrants.

FOCUS STRATEGIES

Focus strategies are those which are designed to help an organization target a specific niche within industry. As against low cost leadership and differentiation strategies which are designed to target a broader or industry wide market, focus strategies aim at a specific and typical small niche such as –

- Particular buyer group
- A narrow segment of given product line
- A geographical or regional market, and
- A niche with distinctive special taste and preferences.

The basic idea behind a focus strategy is to specialize the firm activities in ways

that other borderline (low cost or differentiation) organization cannot perform as well. Superior value, and thus, higher profitability is generated when other borderline organizations cannot specialize their activities as well as a focused organization.

Overall, the organizations which practice focus strategies generally remain highly profitable even when the broader industry appears to be unattractive. The biggest disadvantages facing the focus/specialize strategy is the risk that underlying market niche may gradually shift more towards characteristics of the broader market. Distinctive tastes and product characteristics may blur over time thus, reducing defensibility of the niche.

The focus strategy concentrates on a narrow segment and within that segment attempts to achieve either a cost advantage or differentiation. The premise is that the needs of the group can be better serviced by focusing entirely on it. A firm using a focus strategy often enjoys a high degree of customer loyalty, and this entrenched loyalty discourages other firms from competing directly.

Because of their narrow market focus, firms pursuing a focus strategy have lower volumes and therefore less bargaining power with their suppliers. However, firms pursuing a differentiation-focused strategy may be able to pass higher costs on to customers since close substitute products do not exist. Organizations which succeed in a focus strategy are able to tailor a broad range of product development strengths to a relatively narrow market segment that they know very well.

Some risks of focus strategies include imitation and changes in the target segments. Furthermore, it may be fairly easy for a broad-market cost leader to adapt its product in order to compete directly. Finally, other focusers may be able to carve out sub-segments that they can serve even better.

INTEGRATION STRATEGIES

Integration strategies seek mainly, but not exclusively, to acquire a service or product by merging with or acquiring the prior provider. Therefore, the process of integration should be implemented within a framework of goals that spells out the limits of such evaluative criteria as return on sales and investment, pivotal expense items, time, and cash flow. Integration strategies can be achieved in the following ways:

(i) Backward Integration

Backward integration involves gaining increased control over the firm's supply (or input) activities. It can be implemented through merger with or acquisition of the organization that produces the company's inputs or by growing one's own supply systems. However, it is often easier to finance an acquisition than internal expansion.

The main reasons to support the backward integration are:

- (a) getting regular and adequate supply of inputs;
- (b) enjoying the benefits of enhanced quality control;
- (c) getting higher return on investments by better use of facilities;
- (d) improving negotiation power with suppliers;
- (e) saving indirect taxes payable on purchase of inputs.

(ii) Forward Integration

Forward integration consists of obtaining control over the external portions of the organizations marketing systems. This is down stream expansion which refers to moving higher up in the production and or distribution process towards the end user or consumer. In most cases this means either acquiring a distribution system or establishing one internally. **A textile unit produces cloth, opens its own retail outlet** is an example of forward integration.

(iii) Horizontal Integration

Horizontal integration refers to a situation when two or more firms engaged in similar activities think of joining hands for their betterment. Integration is the order of the day particularly with sweeping phase of globalization. **Associated Cement Company** is the clear case of horizontal integration where these companies get better off in the areas of production, finance, marketing, human resource, research and development, than when they were alone.

(iv) Vertical Integration

Vertical integration is a case when a firm accepts either earlier activities or the latter activities than what it is engaged in the series of activities that start converting raw materials till the handling over of the end products to the class of consumers. In a sense, vertical integration permits the organization to enlarge its scope of operations within the same overall industry. It is characterized by the firm's expansion into other parts of industry value chain directly related to the design, production, distribution and marketing using existing set-off products or services. For example, **a dyeing unit takes over the spinning, weaving, bleaching and printing, finishing and marketing** is a case of vertical integration.

Further, vertical integrations strategy may be full or partial. Full vertical integration is a situation when the organization seeks to control all stages of value chain related to final end product or services. As against this, partial integration refers to a selective choice of these value adding stages that are brought in house. Under this, the organization attempts to control only strategically important or valuable activities but rely on external provider to outsource activities which do not match their core competency or strength.

DIVERSIFICATION STRATEGIES

Diversification strategies refers to those strategies in which growth objectives are sought to be achieved by adding new products or services to the existing product or service line. Management group too often looks to diversification as a way of covering less-than-satisfactory performance in its present activities. Diversification has the best chance of success when the business chosen fits the strategy and when it is attempted by managements who have mastered their current strategies. Those who have been unable to successfully manage one business or set of businesses, will probably find greater difficulty in managing an additional business.

There are two different diversification approaches i.e.

- (i) Concentric Diversification or Related Diversification;

- (ii) Conglomerate Diversification or Unrelated Diversification.

Concentric Diversification or Related Diversification

Concentric diversification or related diversification occurs when a firm adds related products or markets. The goal of such diversification is to achieve strategic fit. Strategic fit allows an organization to achieve synergy. In essence, synergy is the ability of two or more parts of an organization to achieve greater total effectiveness together than would be experienced if the efforts of the independent parts were summed. Synergy may be achieved by combining firms with complementary marketing, financial, operating, or management efforts. Breweries have been able to achieve marketing synergy through national advertising and distribution. By combining a number of regional breweries into a national network, beer producers have been able to produce and sell more beer than had independent regional breweries.

Financial synergy may be obtained by combining a firm with strong financial resources but limited growth opportunities with a company having great market potential but weak financial resources. For example, debt-ridden companies may seek to acquire firms that are relatively debt-free to increase the leveraged firm's borrowing capacity. Similarly, firms sometimes attempt to stabilize earnings by diversifying into businesses with different seasonal or cyclical sales patterns.

Strategic fit in operations could result in synergy by the combination of operating units to improve overall efficiency. Combining two units so that duplicate equipment or research and development are eliminated would improve overall efficiency. Quantity discounts through combined ordering would be another possible way to achieve operating synergy. Yet another way to improve efficiency is to diversify into an area that can use by-products from existing operations. For example, breweries have been able to convert grain, a by-product of the fermentation process, into feed for livestock.

Management synergy can be achieved when management experience and expertise is applied to different situations. Perhaps a manager's experience in working with unions in one company could be applied to labor management problems in another company. Caution must be exercised, however, in assuming that management experience is universally transferable. Situations that appear similar may require significantly different management strategies. Personality clashes and other situational differences may make management synergy difficult to achieve. Although managerial skills and experience can be transferred, individual managers may not be able to make the transfer effective.

Conglomerate Diversification or Unrelated Diversification

Conglomerate diversification or unrelated diversification occurs when a firm diversifies into areas that are unrelated to its current line of business. Synergy may result through the application of management expertise or financial resources, but the primary purpose of conglomerate diversification is improved profitability of the acquiring firm. Little, if any, concern is given to achieving marketing or production synergy with conglomerate diversification.

One of the most common reasons for pursuing a conglomerate growth strategy is that opportunities in a firm's current line of business are limited. Finding an attractive investment opportunity requires the firm to consider alternatives in other types of business. Philip Morris's acquisition of Miller Brewing was a conglomerate move. Products, markets, and production technologies of the brewery were quite different from those required to produce cigarettes.

Firms may also pursue a conglomerate diversification strategy as a means of increasing the firm's growth rate. Growth in sales may make the company more attractive to investors. Growth may also increase the power and prestige of the firm's executives. Conglomerate growth may be effective if the new area has growth opportunities greater than those available in the existing line of business.

Probably the biggest disadvantage of a conglomerate diversification strategy is the increase in administrative problems associated with operating unrelated businesses. Managers from different divisions may have different backgrounds and may be unable to work together effectively. Competition between strategic business units for resources may entail shifting resources away from one division to another. Such a move may create rivalry and administrative problems between the units.

Caution must also be exercised in entering businesses with seemingly promising opportunities, especially if the management team lacks experience or skill in the new line of business. Without some knowledge of the new industry, a firm may be unable to accurately evaluate the industry's potential. Even if the new business is initially successful, problems will eventually occur. Executives from the conglomerate will have to become involved in the operations of the new enterprise at some point. Without adequate experience or skills (management synergy) the new business may become a poor performer.

Without some form of strategic fit, the combined performance of the individual units will probably not exceed the performance of the units operating independently. In fact, combined performance may deteriorate because of controls placed on the individual units by the parent conglomerate. Decision-making may become slower due to longer review periods and complicated reporting systems.

Internal Diversification

Diversification efforts may be either internal or external. Internal diversification occurs when a firm enters a different, but usually related line of business by developing the new line of business itself. Internal diversification frequently involves expanding a firm's product or market base.

One form of internal diversification is to market existing products in new markets. A firm may elect to broaden its geographic base to include new customers, either within its home country or in international markets. A business could also pursue an internal diversification strategy by finding new users for its current product.

Illustration:

Arm & Hammer marketed its baking soda as a refrigerator deodorizer.

Finally, firms may attempt to change markets by increasing or decreasing the price of products to make them appeal to consumers of different income levels.

Another form of internal diversification is to market new products in existing markets. Generally this strategy involves using existing channels of distribution to market new products. Retailers often change product lines to include new items that appear to have good market potential.

Illustration:

Johnson & Johnson added a line of baby toys to its existing line of items for infants. Packaged-food firms have added salt-free or low-calorie options to existing product lines.

It is also possible to have conglomerate growth through internal diversification. This strategy would entail marketing new and unrelated products to new markets. This strategy is the least used among the internal diversification strategies, as it is the most risky. It requires the company to enter a new market where it is not established. The firm is also developing and introducing a new product. Research and development costs, as well as advertising costs, will likely be higher than if existing products were marketed. In effect, the investment and the probability of failure are much greater when both the product and market are new.

External Diversification

In external diversification the company enters a new arena of business by purchasing another company or business unit. Mergers and acquisitions are common forms of external diversification. External diversification occurs when a firm looks outside of its current operations and buys access to new products or markets. Mergers are one common form of external diversification. Mergers occur when two or more firms combine operations to form one corporation, perhaps with a new name. These firms are usually of similar size. One goal of a merger is to achieve management synergy by creating a stronger management team. This can be achieved in a merger by combining the management teams from the merged firms.

Acquisitions, a second form of external growth, occur when the purchased company loses its identity. The acquiring company absorbs it. The acquired company and its assets may be absorbed into an existing business unit or remain intact as an independent subsidiary within the parent company. Acquisitions usually occur when a larger firm purchases a smaller company. Acquisitions are called friendly if the firm being purchased is receptive to the acquisition. Mergers are usually friendly. Unfriendly mergers or hostile takeovers occur when the management of the firm targeted for acquisition resists being purchased.

Vertical and Horizontal Diversification

Diversification strategies can also be classified by the direction of the diversification. Vertical integration occurs when firms undertake operations at different stages of production. Involvement in the different stages of production can be developed inside the company (internal diversification) or by acquiring another firm (external diversification). Horizontal integration or diversification involves the firm

moving into operations at the same stage of production. Vertical integration is usually related to existing operations and would be considered concentric diversification. Horizontal integration can be either a concentric or a conglomerate form of diversification.

RATIONALE FOR DIVERSIFICATION AND INTEGRATION

The purpose of diversification is to build shareholders value. Diversification build shareholders value when diversified group of businesses can perform better under the auspices of a single corporate parent than they would as independent stand alone businesses. Diversification becomes attractive strategy when a company runs out profitable growth opportunities in its core business.

Even though the advantages of concentration may be significant, certain forces cause integration and diversification to be favorable strategies for some businesses. They are as follows:

- (i) *Psychological Pressure*: Business owners as well as managers simply get tired of doing the same thing. The possibility of expanding by diversification or integration, of facing the challenges of a new set of business circumstances, is often too attractive to forego.
- (ii) *Optimal Size*: Diversification and integration enable the organization to attain its optimal size and avail all economies.
- (iii) *Increase in Profitability*: Integration can increase profitability by turning a cost center into a revenue (and profit) centre. Organizations which integrate can then operate the new business as a profit center while also serving the needs of the old business. Integration by merger rather than internal development tends to reduce the costs also.
- (iv) *Increase Control*: A related integration pressure is the desire to increase control of supply streams to correct inconsistencies in quality or delivery schedules, or unreliability of distributors, when they become intolerable.
- (v) *Faster Growth*: Growth is a new terrain which attract a business unit for diversification. Diversification offers to an organization an opportunity for faster growth in terms of rapid expansion, economies of scale and learning new skills. It is through access of the organization to potential new sources of technologies and skills and their application into new products and market. In time these resources become the basis for future industries.
- (vi) *Profitability*: The desire for higher profitability also leads organization to search for new terrain. New terrain may be less competitive thereby enabling an organization to earn a higher rate of return.
- (vii) *Stability*: The new terrain may be more stable than a organization base business in terms of the cyclical nature and fluctuations of output. Organization some time faces huge price swing in the core business, which leads to distortions in both production planning and pricing of product. Diversification into businesses with different industry cycle enables a firm to generate to more predictable level of sales and profits. By expanding to a field with more characteristics an organization sometimes moves away from problems in its core business.

- (viii) *Access to Resources*: Another common motive to diversification is a desire to secure access to resources. By acquiring an organization which possesses a scarce resource or market position, a business unit can significantly improve its own competitive position. Similarly, a business unit which possesses a critical resource can often improve the position of another business unit by acquiring and transferring the resources to it. Resources frequently acquired and transferred in this way are physical assets, technologies and expertise.
- (ix) *Sharing Activities*: Sharing activities is another rationale for diversification for a business unit. It is basically a desire to share one or more value chain activities among businesses. This type of arrangement avoids unnecessary duplication. It enables businesses to operate activities on a larger scale than otherwise would be possible for any single business operating on its own. Sharing an activity produces greater economy of scale and thus lower total cost of production. Sharing also offers the prospects of faster learning and application of new scales and technology to new areas, thus effective sharing of key resources among business units lays the strong foundation for building sound, strong highly inimitable core competencies.

COST OF DIVERSIFICATION

Despite various benefits of diversification/integration, it imposes certain costs also which include the following:

- (i) *Cost of Ignorance about New Areas*: Business units which diversify into new areas are generally not well informed and thus not able to articulate consumer needs, products technology developments and environmental changes. All this deficiency place the organization in disadvantageous position as compared to competitors. This ultimately leads to or increases the probability to miss the opportunity and commit costly errors.
- (ii) *Cost of Neglecting the Core Business*: Diversification is critical decision and subject to clearance of top management after thorough deliberations inside the organizations and in the light of advises of consultants and bankers outside the organization. All this effort is a time consuming exercise and distract the attention of organization from the core business activities.
- (iii) *Cost of Co-operation*: Another disadvantage of diversification is cost of co-operation to share common resources. It basically includes cost associated with communication, compromise and accountability. To share an activity, business units must be in agreement on such issues as objectives, resources to be allocated, scheduling of new products, reporting structure of personnel. To resolve this type of vital issues, there is a need for effective communication which cost the organization in terms of time. Compromise results in political differences and reduces strategic flexibility for both the organizations.

Organizations have to incur the cost in terms of accountability also. Accountability is reduced if a business unit is asked to co-operate with other units, since its performance will than be influenced perhaps to a large extent, by compromises it makes to work with other units.

DEFENSIVE STRATEGIES

Not all strategies have expansion orientation. Very often the strategist is forced to control the firm's operations. Except for the rare attempt by a firm's owners to simplify their lives by shrinking their business's size, contraction is usually a defensive response to adversity. There are three basic types of defensive strategies i.e., retrenchment, divestment and liquidation.

(i) Retrenchment Strategies

It includes those strategies which attempts to regain control of a faltering business or to prevent it from faltering in the first place by temporarily reining in its operations. Retrenchment can generally take two major forms i.e.: shallow retrenchment and deep retrenchment.

- (a) *Shallow Retrenchment*: This is a response to adversity characterized by small but significant reduction in expenditures for expense items, asset investment, or both. It would normally follow a decision to lighten emphasis on sales growth for a certain time period. To illustrate, this strategy would be appropriate for a growing firm facing a cash flow shortage. Policies accompanying shallow retrenchment in this case might include selling only to high-quality (fast paying) accounts, cutting costs to reduce cash requirements. Shallow retrenchment would continue until a targeted level of net cash flow or some other goal met. Then the former growth strategy, or a variation, would replace it. As such, shallow retrenchment is an emphasis-switching exercise to build internal strength. The kinds of activities which would characterize shallow retrenchment generally include reducing hiring rates, laying workers off, delaying asset replacement, dropping narrow margin products or lines, reducing inventory levels, stretching payables or other moves aimed at decreasing operating expenses, increasing net cash flows, and reducing asset investment rates.
- (b) *Deep Retrenchment*: This involves severely curtailing operations as a defense against major economic adversity, financial reverses, competitive disadvantage, or a drastic threat to sales growth or profitability that cannot be met with an offensive move. For shallow retrenchment, management is willing temporarily to de-emphasize growth in order to trim some fat and there is usually an implicit expectation to reinstate the former growth strategy. By contrast, deep retrenchment is characterized by the intention to change at least part of strategy, usually by surgery in the product, market, or business-definition areas. The company would plan to exit from deep retrenchment as a different company, with fewer or different product/lines, different organization structure, fewer or different markets or segments, and so forth. Clearly the distinction between shallow and deep retrenchment is subjective and a matter of degree, the idea of intended change in strategy provides a useful distinction.

(ii) Divestment Strategies

Sometimes, it may not be possible for the organization to carry on a particular line of a business because it does not offer any potential event after turnaround

action. In that case, the organization tries to get rid off that business by pursuing a divestment or divestiture strategy. Divestiture or divestment means ridding the organization or sub-unit usually by selling it.

Profitability shrinkages, sales declines, and other operational problems of a diversified firm may be curable by divestment when at the root of the problem is an ill-fitting subsidiary or business unit. Actually divestment is more a matter of abandoning a misfit than it is a strategic orientation, except in instances where it is part of a strategy designed to rehabilitate ailing acquisitions subsequently to be spun off.

Although diversified firms often have divestment guidelines to handle the problem of separating ill-fitting businesses, divestment can constitute a strategic posture for some firms.

The three fundamental types of divestment are – (a) sell-off, (b) spin-off, and (c) split off.

- (a) **Sell-off:** The distinction between a sell-off and a spin-off is blurred because both can be accomplished by the sale of a subsidiary. The difference seems to be the intentions of the parent firm. If it sells a business unit that it had originally intended to keep, it is typically a sell-off. However, if the intention in acquiring or growing the subsidiary had been subsequently to sell it, then it is labeled a spin-off.
- (b) **Spin-off:** To be more precise, spin-off is a form of corporate restructuring where an organization sells those units or parts of a business which no longer contribute to or fit the organization's distinctive competence. Spin-offs can involve sales of assets to another organization or to the public. The rationale of spin off is to unlock the hidden value of assets or business which in turn flounder with excessive diversification and reduced corporate focus.
- (c) **Split-off:** By contrast a split-off is a divorce of two approximately equal-sized business units or divisions. Once share ownership is shuffled the two units do separate business.

(iii) Liquidation

Liquidation means converting an asset, sub unit or organization to cash. When a firm or unit of a firm is not to continue the business, it can be liquidated. Of course, when this happens, the firm ceases to exist. Firms are liquidated due to financial distress or failure to locate a buyer for divestment. Its assets are sold item by item and the proceeds are distributed among creditors. Funds left over after payment to creditors and meeting liquidation costs are distributed among shareholders.

Liquidation can be accomplished via one of three possible avenues i.e., voluntary closure, assignment, and insolvency.

- (a) **Voluntary Closure:** Voluntary closure takes place when a firm simply pays off its creditors, closes its doors, and quietly goes out of business. Voluntary closure basically implies that the firm or its owner has sufficient cash or

liquid assets to pay off creditors. Typically, voluntary closure is more prevalent among small businesses than large ones.

The decision-maker can focus attention on the liquidating value of owner's equity—the market value of assets less the amount of debt outstanding to determine the advisability of voluntary liquidation. Presumably if the firm's going concern value is greater than its liquidating value of equity, the owners will not liquidate instead they will seek to sell it as a going concern.

- (b) *Assignment*: Assignment involves the transfer of title of assets to a third party. The trustee or assignee then sells the assets and distributes the proceeds among creditors, according to the magnitude of their claims. To be precise, it is a way of liquidating the debt of an insolvent firm while preventing mounting costs associated with formal bankruptcy proceedings.
- (c) *Insolvency*: Liquidation under the Insolvency Laws of the country is appropriate when the liquidating value of assets is exceeded by debt; that is, when the firm is insolvent and the market value of assets is insufficient to pay outstanding debt. The primary feature of liquidation under the Insolvency laws is that all obligations are discharged automatically and the owners can start a new business unhampered by the burden of prior debt.

Strategies:



Offensive strategies: are those strategies which are employed by management to reach goals related to increase in sales or market share, and in some cases, profitability.

Focus strategies: are those which are designed to help an organization target a specific niche within industry.

Integration strategies: seek mainly, but not exclusively, to acquire a service or product by merging with or acquiring the prior provider. Therefore, the process of integration should be implemented within a framework of goals that spells out the limits of such evaluative criteria

Diversification strategies: refers to those strategies in which growth objectives is sought to be achieved by adding new products or services to the existing product or service line.

Defensive strategies: Very often the strategist is forced to control the firm's operations. Except for the rare attempt by a firm's owners to simplify their lives by shrinking their business's size, contraction is usually a defensive response to adversity.

OTHER STRATEGIES

(i) Joint Venture

A joint venture or strategic alliance is a business unit or competitive effort established for a specific purpose, the ownership of which is shared by two or more businesses. It can be used as a way to own and control a business, product line, market, or activity that does not really fit the strategy of either parent. Ideally joint ventures are formed by organizations with complementary or supplementary capabilities, which are unified in the joint venture. Business units join together because of a mutual need for the results of its operation. The reason for managers to involve their companies in joint ventures are as follows:

- (i) To enter new markets and gain access to some critical resources.
- (ii) Policy of various governments to insist that foreign competitors participate in joint ventures with local partners rather than set up a wholly owned subsidiary.
- (iii) Higher degree of financial risks, in project.
- (iv) Insufficient skills and inadequate resources to make the business a success to undertake the project independently.
- (v) Only way for partners to reach acceptable economies of scale in research, marketing, or production.

The three common types of joint ventures may be: (i) unrelated partners, (ii) related partners, and (iii) dual-nationality partners.

- (i) **Unrelated Partners:** These are the firms which are independent and usually in different industries. They pool their respective contributions—resources, skills, technologies, and so on—in the joint venture and share contractually in the results of its operation.
- (ii) **Related Partners:** Joint ventures by related partners are aggregations of similar activities or business units which could not survive alone.
- (iii) **Dual Nationality Partners:** Under this form of joint ventures, organizations join one another to overcome political, social, or cultural obstacles. Many foreign governments allow U.S. firms to do business on their soil only as partners with the local firms in joint ventures.

(ii) Harvesting

Harvesting strategy is popularized by Boston Consulting Group to reduce investment in the hope of cutting costs and improving cash flow. Harvesting strategy basically refers to a strategy which is concerned with the systematic removal of cash and other assets from a slow growth or declining business. It may be thought of a 'milking' business before it loses all its value. The basic objective of harvesting is to generate as much cash from business as possible before the adverse consequence of an environmental threat operates.

Several opinions have been offered concerning the situation in which harvesting is appropriate. According to the Boston Consulting Group (BCG), a business with a low expected growth rate that also enjoys high market share is called a cash cow. Harvesting is the appropriate strategy for such a business.

The following conditions for harvesting strategies have been suggested by Kotler:

- (i) The market is stable or declining.
- (ii) The product is not strategically important.
- (iii) Attempts to increase market share would likely prove costly and futile.
- (iv) Total sales depend little on the unit.
- (v) Opportunity costs are significant.
- (vi) Chances are high that even with reduced support of the product it can continue to produce positive net cash flows, at least for a while.
- (vii) The business entity is not a major component of company's business portfolio.

(iii) Mergers and acquisitions strategies

Mergers and acquisitions are the popular strategies followed by organizations for their growth. A merger is simply the combination of two or more business units. The merger may be achieved by the organization broadly in two ways:

- (i) Acquisition of one business unit by another business unit.
- (ii) Creation of a new company by consolidation of two or more units.

The rationale for merger and acquisitions by the organization may be any of the following:

- (a) Quick entry into markets and industries;
- (b) To avail opportunities for faster growth rate;
- (c) To avail diversification advantages;
- (d) To avail tax benefits;
- (e) To purchase a unit for better use of investible funds;
- (f) To reduce competition by acquiring competing form;
- (g) To improve the efficiency of operations and attain higher profitability through synergistic effect;
- (h) To fill-up the gap in the existing product line;
- (i) To enhance price earnings ratio and market price of shares.

Choose your option:

Name the strategy which was popularized by Boston consulting Group (BCG) and refers to the systematic removal of cash and other assets from a slow growth or declining business.

- (a) Joint Venture**
 - (b) Harvesting**
 - (c) Mergers and acquisitions strategies**
- (b) Harvesting**



EVALUATION OF STRATEGIC ALTERNATIVES

Once the organization identifies various strategic alternatives, the next important step of strategic management process is to make a choice among available alternative strategies. The rationale of strategic choice is to direct resources towards objectives in accordance with chosen strategy.

The alternative strategies may range from offensive strategies to defensive strategies including retrenchment and divestment strategies.

Different approaches are developed by experts to evaluate strategic alternatives and choose the best among them subject to given conditions. Broadly speaking, we can classify the evaluation approach in the following categories:

- (i) Simple Approach
- (ii) Analytical Models Approach.

(i) Simple Approach

Let the strategic alternatives be grouped on the basis of key variables, viz., potential market growth and the firm's competitive position. This is a logical starting point since the appropriateness of the strategic choice depends upon the firm's position in relation to the external market and its competitive position assuming that the firm has or can secure the necessary financial resources. The alternative strategies may thus be said to comprise the following combinations of the two variables:

- (1) Low market growth potential/Weak competitive position.
- (2) High market growth potential/Weak competitive position.
- (3) Low market growth potential/Strong competitive position.
- (4) High market growth potential/Strong competitive position.

The quadrant 1 which represents the defensive situation in the following diagram shows low market growth potential and weak competitive position. The organization may seriously consider the defensive retrenchment or divestment—and use excess cash to invest in areas where profit potential is greater.



Alternative Strategies Reflecting Possible Situations

The quadrant 2 depicts the mixed situation where an organization has high market growth potential and weak competitive position. In this situation, some variant of the combination or mixed strategy is called for. Such organization should either seize the opportunity presented by the high growth market potential and carve out a market segment for itself, or divest itself of the product or service line.

In quadrant 3 the organization is in neutral situation where the organisations having low market growth potential but strong competitive position. In this situation, organization should normally favour a stable growth strategy so as to maintain its market share. Under this situation, it would be desirable for such organization to minimize investments in the low growth areas and thus generate cash for other strategic moves.

The Quadrant 4 depicts growth situation which reflects high market growth potential and strong competitive position. These strategies are ideally suited for growing organization situation. The organization in this situation should aim at maximizing market share so as to prevent competitors from gaining a foothold.

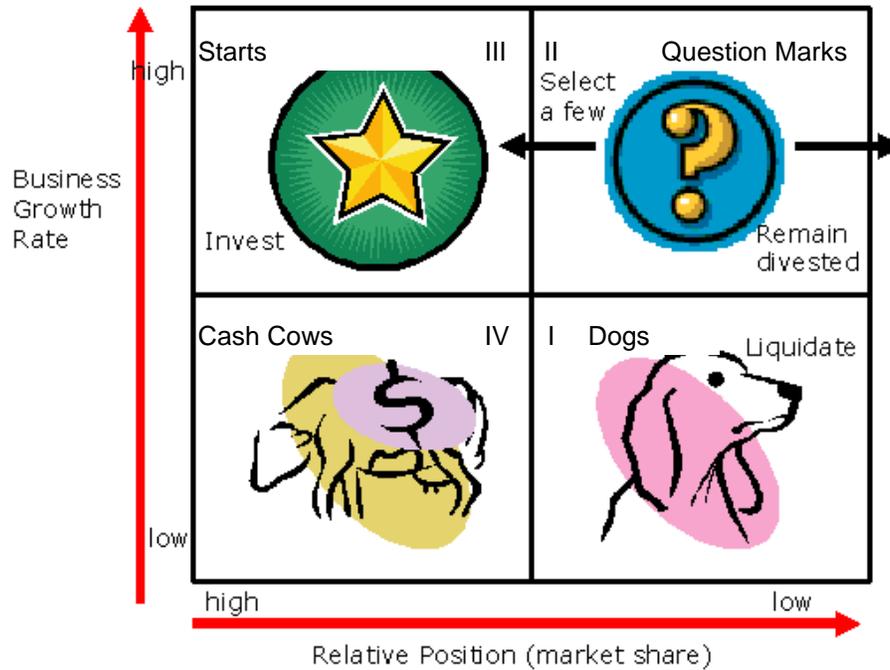
(ii) Analytical Models Approach

A number of analytical conceptual models have been developed by experts for managers to evaluate strategic alternatives before making a choice. Some of them include: Growth share Matrix—Boston Consulting Group (BCG) Model, General Electric's Stoplight Grid, Life Cycle Theory, etc.

BCG Matrix or Growth-Share Matrix (GSM)

The Boston Consulting Group developed the growth-share matrix to analyze the problem of resource deployment among the business units or products of multi-business firms. It is based on product life cycle theory. The business units or products are analyzed by placing each one in the matrix according to their (1) expected growth rate (vertical axis), measured by anticipated growth rate in sales which depends on maturity of industry, and (2) relative market share (horizontal axis), measured as the unit's share divided by that of its largest competitor. The basic idea behind this model is that if a product has a bigger market share or if the products' market grows faster, it is better for the organization. The original BCG model was based on a lifecycle view of the product of a company.

The BCG Matrix



BCG Growth Share Matrix

Thus, the placing products in BCG matrix provide four categories in the portfolio of an organization. Each of the strategic business units' categories shown in the (2x2) matrix is explained as follows

Dogs (Low Growth, Low Market Share)

Each of businesses or products in quadrant I with low expected growth rates and low relative market standing are labeled as "dogs" or "cash traps." The strategy in this category should consist of cost cutting by divestments, retrenchment, or even liquidation. These units or products are likely to be characterized by high costs, low quality, less effective marketing procedures, and so on, which would collectively contribute to weak competitive position and low potential for profits. The strategy for this category should consist of cost cutting.

Question Marks (High Growth, Low Market Share)

Those in quadrant II, with high projected growth rates and low market standing, are labeled as 'Question Mark'. The reason is that although they are operating in markets with expected growth potential, they are otherwise experiencing competitive disadvantage. This quadrant has worst cash characteristics of all, because they have high cash demands and generate low returns because of their low market shares. Management can invest cash to correct the market weakness so as to take advantage of expected market growth or, if not convinced of their ability to improve market share, it can retrench, divest, or liquidate to minimize the cash drain.

Stars (High Growth and High Market)

Products or business units in quadrant III, have both high market standing and high industry growth potential are labeled as stars. They should receive heavy cash investment in order to maintain their market share. Successful resource deployment beyond cash requirements could lead to a superior market share when industry growth potential falls off. Resources should be allocated to these units to grow faster than the competitors in sales and profits. Stars are leaders in the business and generate large amounts of cash.

Cash Cows (Low Growth and High Market Share)

A product or business would become a cash generator in quadrant IV. Cash cows have a strong market position in industries that have matured. These products or businesses can thus be "milked" by investing just enough cash to maintain market standing and applying excess cash inflows to the firm's other activities which are growth industries or products.

In addition to the above implications of the Growth Share Matrix (GSM) for cash management, the matrix also suggests how competitors might be expected to behave in each quadrant. To illustrate, a star performer (market leader with high market share in a rapidly growing industry) usually can expect a serious threat only from cash-rich competitors. Only they can afford to embark upon an expensive program to challenge the probable market leader's cost supremacy and market differentiation.

In comparison with the position of the star performers, cash cows can expect little serious competition because of their relatively low expected industry growth rates. Competitors would likely be reluctant to mount a major offense in the absence of significant industry potential. Thus, a cash cow can enjoy a relatively secure market position, but only as long as sufficient investment in maintaining market share continues.

Quadrant II firms, "question marks," are highly vulnerable by virtue of their low share in high potential growth rate industries. They can expect diverse competitive challenges. Indeed, as small fish in a big sea; question marks can look forward to heavy cash needs to establish themselves as major competitive forces (stars). Business units that fall in quadrant I (Dogs) are probably only marginally profitable and can anticipate little improvement in present markets. They have two major competitive options: (1) get out of the market or (2) develop a major innovation to redefine the market and their participation in it.

Although the growth-share matrix analysis can help in making strategic decisions about managing a portfolio of businesses or products, it has some shortcomings.

- (i) Not all businesses or products fit neatly into one of the four quadrants. Many businesses occupy middle positions between high and low market share and industry growth rate.
- (ii) Other factors besides market share and industry growth rate affect strategy selection. These factors include stage of product/market evolution, strategic fit among the different businesses, the presence of competitive advantages and distinctive competencies, emerging threats and opportunities, vulnerability to

recession, market structure, capital requirements, and size of market. The BCG matrix does not give explicit consideration to these factors.

- (iii) A business's profitability, cash flow and industry attractiveness may not always be closely related to market share and growth rate. Some firms with low market share outperform their larger counterparts, and not all high-share businesses in low-growth industries generate surplus cash.
- (iv) The Growth Share Matrix (GSM) does not offer guidance for inter unit comparisons. For example, in a firm with several cash cows, strict adherence to the matrix implies treating each one in the same way when some might be drained of cash and others managed for cash flow. Also, all stars are not necessarily better than cash cows.

The other limitations include the following:

- It neglects the effects of synergy between business units.
- High market share is not the only success factor.
- Market growth is not the only indicator for attractiveness of a market.
- Sometimes Dogs can earn even more cash as Cash Cows.
- The problems of getting data on the market share and market growth.
- There is no clear definition of what constitutes a “market”.
- A high market share does not necessarily lead to profitability all the time.
- The model uses only two dimensions—market share and growth rate. This may tempt management to emphasize a particular product, or to divest prematurely.
- A business with a low market share can be profitable too.
- The model neglects small competitors that have fast growing market shares.

GE Matrix/McKinsey Matrix

The GE matrix/McKinsey matrix is a model to perform a business portfolio analysis on the Strategic Business Units of a company. A business portfolio is the collection of strategic business unit that makes up a corporation. The optimal business portfolio is one that fits perfectly to the company's strength and helps to exploit the most attractive industries or market. A strategic basic unit (SBU) can either be an entire mid size company or division of a large corporation that formulates its own business level strategy and has separate objectives from the parent of the company.

The aim of a portfolio analysis is to:

- (a) Analyze its current business portfolio and decide which SBU's should receive more or less investment, and
- (b) Develop growth strategies for adding new products and businesses to the portfolio
- (c) Decide which businesses or products should no longer be retained.

The GE/McKinsey Matrix is a better and more advanced form of the BCG Matrix. It is more sophisticated in the following aspects:

1. Market (Industry) attractiveness replaces market growth as the dimension of

industry attractiveness. Market attractiveness includes a broader range of factors other than just the market growth rate that can determine the attractiveness of an industry/market.

2. Competitive strength replaces market share as the dimension by which the competitive position of each Strategic Business Unit (SBU) is assessed. Competitive strength likewise includes a broader range of factors other than just the market share that can determine the competitive strength of a Strategic Business Unit.
3. Finally the GE/McKinsey Matrix work with a 3 x 3 grid, while the BCG Matrix has only 2x2. This also allows for more sophistication.

Mechanism and Implication of GE/McKinsey Matrix

The matrix is a model to perform a business portfolio analysis on the strategic business unit of a company. The model advocates that organization strategic decision ought to be made on the basis of two important parameters i.e. industry attractiveness and business strength which is shown on the vertical and horizontal axis of matrix in the figure.

Industry Attractiveness: The industry attractiveness is determined by the following factors:

- Market size
- Market growth rate
- Market profitability
- Pricing trends
- Competitive intensity / rivalry
- Overall risk of returns in the industry
- Entry barriers
- Opportunity to differentiate products and services
- Demand variability
- Segmentation
- Distribution structure
- Technology development

Each factor is assigned a weight which is appropriate to industry. The industry attractiveness then is worked out as under:

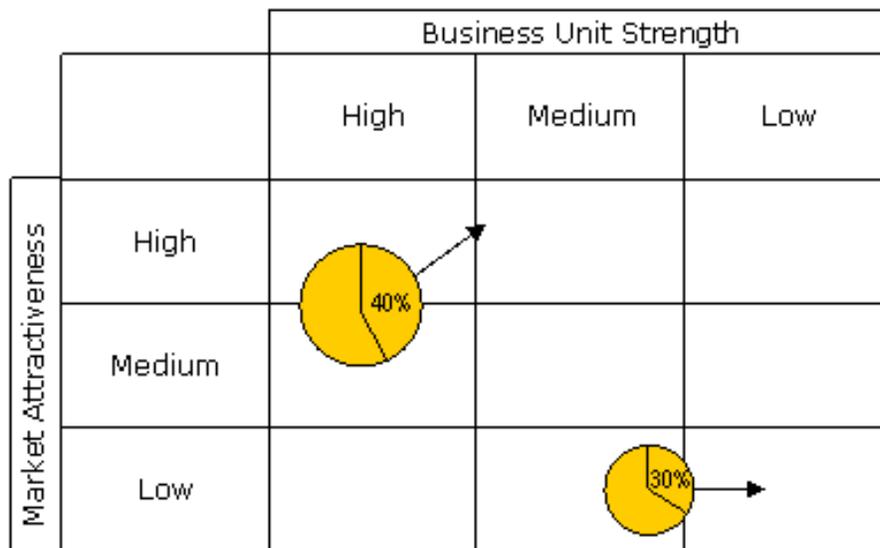
$$\text{Industry attractiveness} = \text{Factor value}_1 \times \text{Factor Weighting}_1 + \dots + \text{Factor value}_n \times \text{Factor Weighting}_n$$

Business Strength: Business strength of a unit is another parameter in GE/McKinsey Matrix in strategic decision –making and is influenced by numbers which are listed as under:

- Strength of assets and competencies
- Relative brand strength (marketing)
- Market share

- Market share growth
- Customer loyalty
- Relative cost position (cost structure compared with competitors)
- Relative profit margins (compared to competitors)
- Distribution strength and production capacity
- Record of technological or other innovation
- Quality
- Access to financial and other investment resources
- Management strength

GE / McKinsey Matrix



The matrix model is based on stop light strategy which works on analogy of traffic control lights at street crossing i.e. green (Go), Yellow (Caution) and Red (Stop).

If a product falls in green i.e. go category, it indicates that business position is strong and industry attractiveness is medium. In this case, the decision of business unit should be to invest, expand and diversify. If a product falls in the yellow i.e. caution category, then this implies that the business strength is low and industry attractiveness is high. So the company should be cautious while making decisions. The last category is red i.e. stop, which indicates that business strength and industry attractiveness both are low. Here the optimal strategy should be to liquidate.

Strategic Business Units in the above matrix are portrayed as a circle plotted in the GE/McKinsey Matrix, whereby:

- The size of the circles represents the market size

- The size of the pies represents the market share of the Strategic Business Units
- Arrows represent the direction and the movement of the Strategic Business Units in the future.

A business unit is located by first determining whether its relative business strengths are high, medium, or low (vertical axis) through assessment of such factors as sales growth rate, market share, market image, and management capabilities. Its high, medium, or low ranking on the horizontal axis (industry attractiveness) is a function of the size and potential of its market; technological status, financial health, competitive structure, and social and political characteristics of its industry; and economic circumstances. Rankings on both axis for each unit is decided on the basis of cell among the nine cells in the grid it occupies. Business units with high or medium industry attractiveness either have medium or high strengths call for an "invest and grow" decision—a green-light strategy.

Medium or low industry promise coupled with medium or low strength of a business unit operating in that industry would indicate a red-light strategy—minimal additional investment by business unit with expected continued earnings generation. The company may resort to retrenchment or limited technological support of red units.

Combinations of industry attractiveness and business strength scores that place a business unit in one of the yellow-light cells could be either a borderline case or composed of both red and green elements.

A six-step approach to implementation of GE/ McKinsey Matrix:

1. Specify drivers of each dimension. The company must carefully determine those factors that are important to its overall strategy.
2. Determine weight of each driver. The company must assign relative importance weights to the drivers.
3. Score Strategic Business Units on each driver.
4. Multiply weights time's scores for each Strategic Business Unit.
5. View resulting graph and interpret it.
6. Perform a review/sensitivity analysis using adjusted weights (there may be no consensus) and scores.

Limitations of the GE matrix/McKinsey Matrix:

- Valuation of the realization of the various factors
- Aggregation of the indicators is difficult
- Core competencies are not represented
- Interactions between Strategic Business Units are not considered
- Ineffective in portraying the circumstances of new businesses whose growth in new industries is just beginning.

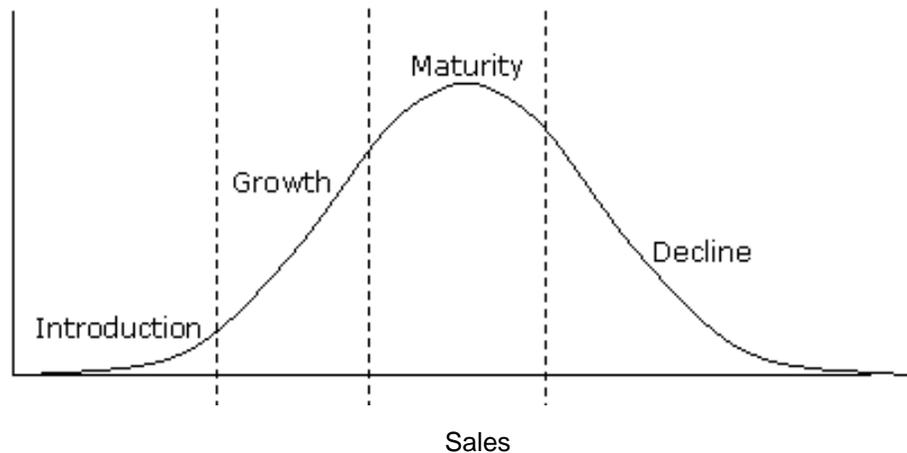
LIFE CYCLE ANALYSIS

Life cycle analysis relies on the belief that there are predictable relationships

among the stages in product or business unit life cycles on one hand, and certain elements of strategy on the other.

The typical product life cycle curve is analogous to the life cycle of biological organisms. Note the relationship between unit profit margin and sales revenues at the different stages. During pre-introduction and introduction, the firm is investing heavily to build sales, grow through product awareness and refinement, with emphasis on the latter. Thus, profit margin is negative until growth begins to occur. If sales growth precedes at a high enough rates, then unit profit margin will swing positive during the growth phase. Typically, the firm's emphasis is shifted from product refinement to building market share, thus, increasing the length and slope of the curve during this phase.

Product (Industry) Life Cycle stages



As more and more competitors enter the market, the product's growth rate begins to level off and the product enters the maturity stage. During growth, ever-increasing sales volume can derive unit profit margin higher and higher. As competitive pressures mount, profit margin is eaten away. Emphasis shifts to production efficiency as management attempts to maintain profit margin during the maturity phase.

Finally, as sales decline, attention is concentrated on maintaining cash flow. Often a policy is in place that makes product discontinuance, a function of the magnitude of net cash flow.

In multi product organization attention is focused on the net effect on sales, profit margins, and cash generation of the performance of the organization stable of products.

Multi business organizations that are conglomerates or holding companies can be viewed as a collection of multi-product organization. Of course, the life cycle curves of the separate Strategic Business Units would not line up as neatly as they do in the diagram, but rather would be super-imposed on each other in a complex

network of curves. However, corporate-level management is concerned with balancing the performance of a collection of Strategic Business Units. Overall conglomerate sales can be influenced by the addition or deletion of Strategic Business Units or by altering the performance of them.

Life cycle curves can be useful devices for explaining the relationships among sales and profit attributes of separate products, collections of products in a business, and collections of businesses in a conglomerate or holding company. Life cycle analysis has been suggested as a basis for selecting appropriate strategy characteristics at all levels.

Introduction Stage Strategies

During the early stages of the life cycle, marketing strategy should focus on correcting product problems in design, features, and positioning so as to establish a competitive advantage and develop product awareness through advertising, promotion, and personal sales techniques. At the same time, personnel strategy could focus on planning and recruiting human resources for new product and dealing with union requirements. Also, one would expect the nature of research and development strategy to shift from a technical research orientation during pre introduction to more of a development orientation during actual introduction.

Financial strategy would be likely to address primarily sources of funds needed to fuel research and development and marketing efforts as well as the capital requirements of later production facilities. Capital budgeting decisions would be outlined during these early stages so that capacity would be adequate to serve growth needs when sales volume begin to accelerate.

Growth Stage Strategies

During the growth stage, strategies emphasize change relative to introduction. Marketing strategy is concerned with quickly carving out a niche for the product or firm and for its distribution capabilities, even when doing so might involve taking risks with over capacity. Too often, firms have unadvisedly accepted quality shortfalls as a necessary cost of rapid growth. Widening profit margins during growth may even permit certain functional inefficiencies and risk taking. Communication strategy is directed towards establishing brand preference through heavy media use, sampling programs, and promotion programs, strategy should emphasize resource acquisition to maintain strength and development of ways to continue growth when it begins to slow.

Personnel strategy may focus on developing loyalty, commitment, and expertise. Training and development programs and various communication systems are established to build management and employee teams that can deal successfully with the demands of impending tight competition among firms during the maturity phase.

Maturity-Stage Strategy

Efficiency and profit-generating ability become major concerns as products enter the maturity stage. Competition grows as more firms enter the market and the implication is that only the most productive firms with established niches and competent people will survive.

Marketing efforts concentrate on maintaining customer loyalty and in strengthening this with distributors through sales promotions and publicity. Production strategy concentrates on efficiency and at the same time, sharpens the ability to meet delivery schedules and minimize defective products. Cost control systems are often put in place. Personnel strategy may focus on various incentive systems to produce manufacturing efficiency. Promotions and transfers are used and some firms try to adopt management positions to personalities who are attuned to the needs of products at the maturity stage.

Decline-Stage Strategies

When a product reaches the point where its markets are saturated, an effort is often made to modify it so that its life cycle is either started renew or its maturity stage extended. When downfall of sales of a product cannot be reversed and it enters the decline stage, management's emphasis may switch to milking it dry of all profit. Advertising and promotion expenditures are reduced to a minimum. People are transferred to new positions where their experience can be brought to bear on products in earlier growth stages.

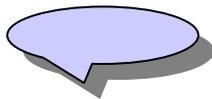
Various strategies have been suggested for products that have entered the decline stage. Some of them are: (1) concentration on a small market segment and reduction of the firm's asset base to the minimum levels needed for survival (2) acquisition of several similar firms so as to raise sales to a substantial percent of the leaders' sales; (3) selling out to a buyer with sufficient cash resources and the willingness to use them to effect a turnaround; and (4) liquidation.

Limitation of Life Cycle Analysis

Although life cycle analysis has been widely advocated, its critics suggest that it should be used with caution. Kotler explains that as a planning tool and a control tool, it is useful in outlining choices and monitoring progress, respectively. But its usefulness as a forecasting tool is limited.

The principal difficulties with life cycle theory are that: (1) its patterns vary too widely, (2) identifying the stage of a product is actually difficult, (3) it may be readily biased by marketing strategy decisions, and as such, the curve itself is a dependent, not an independent variable.

Product Life Cycle Stage



Introduction Stage Strategies: During this stage the firms investments are high and profit margins are negative.

Growth Stage Strategies: During this stage, growth begins to occur. The firms get a risk taking capability and due to this at times quality shortfalls start occurring

Maturity-Stage Strategy: As more and more competitors enter the market, efficiency and profit-generating ability become major concerns as products enter the maturity stage.

Decline-Stage Strategies: When a product reaches the point where its markets are saturated, an effort is often made to modify it so that its life cycle is either started renew or its maturity stage extended.

SELECTION OF BEST ALTERNATIVE

Several structures have been proposed for testing the acceptability of a chosen strategy. They consist of lists of criteria that the goals and action plans should meet. They can be used as the elements on one axis of a matrix and has the strategy set choices arranged on the other. Then each strategy can be scored on each criteria. The sum of criteria scores for each strategy can then be used to select the best one(s). In this way the criteria can be used in place of other measures of strategy acceptable in a modified rational model. The strategy choice criteria have been synthesized as under:

The selected strategy should be consistent with the—

- (a) Organization's environment,
- (b) Internal capabilities and characteristics,
- (c) Available resources, and
- (d) Risk preferences.

The action plan choices should be aimed at clearly identified goals (objectives and targets) and should have a high chance of successfully reaching or guiding behavior towards them.

The selected strategy should have appropriate timing.

The strategy choice should allow sufficient flexibility for adjustment to deal with competitors' responses and environmental changes. The organization's leadership should be committed to support the chosen strategy.

Each of the above criteria is discussed in detail as under:

(1) Consistency Tests

Following consistency tests should be performed on the selected strategy.

Environmental Factors: The selected strategy should be consistent with the environmental factors identified during the environmental analysis. The selected strategy should address the major threats and opportunities, both present and future. One of the major purposes of the strategy is to integrate the organization and the environment. Integration can take place by taking advantage of opportunities and avoiding or overcoming threats to the organization.

Internal Characteristics: The chosen strategy should be consistent with major internal characteristics of the organization, whose competencies and skills should be incorporated into the strategy so that they become emphasized. Weaknesses should be addressed so that they can be corrected within an appropriate amount of time. Another internal characteristic is management capability. Selected strategy must be implementable by either the present management or new management. Also, the

ways in which the new strategy relates to past strategy should be clear. There is a strong relationship between past strategy and new strategy. The ways in which the new one is expected to improve and the old should be understood.

Resource Availability: New strategy should be consistent with physical facilities and the availability of financial resources in the present and future. Future resource needs should be within the organization's capability and understood in detail. Proforma financial statements should be constructed to show the financial impact on the organization of the new strategy to demonstrate the ability of the firm to produce the necessary resources.

Risk/Return Preference: The final consistency test involves making sure that the selected strategy suits well with the risk/return preference of management and owners. Risk-takers will be inclined toward strategies that involve relatively high levels of risk which commensurate high possible payoffs. They tend to stress organizational strengths and environmental opportunities, operate with confidence and aggressiveness to tackle challenges.

Alternatively risk-averters prefer more defensive, conservative strategies. They will try to stay within present capabilities without entering into projects requiring new strengths or skills, will talk at uncertainty, and will tend to be followers rather than leaders in their markets.

(2) Clarity of Goals

The selected action plans should be linked with clearly understood objectives and targets, especially those related to profit performance. It will be difficult to monitor performance when action plans are not fitted to goals that are widely adopted and understood.

In addition to relating clearly to goals, the selected action plans should have a high chance of reaching them by minimizing the effectiveness of competitors' counter attacks. There are two considerations:

- (i) Strategy should avoid direct confrontation with rivals in areas where they are strongest. Rivals will often respond with less conviction when they do not perceive a direct attack on one of their strengths. The large amount of investment necessary to mount a successful challenge to competitors' strengths may actually prohibit such a move. If it is done with too little investment, it can carry a higher chance of failure than would typically be true if the competitor were weaker on this attribute.
- (ii) Attacking a competitor's weaknesses, a less risky alternative, may carry insufficient return to justify the offensive. For example, a primary weakness of major automobile manufacturers is their inability to produce truly "one-of-a-kind" cars. Many attempts have been made world-wide to capitalize on this "weakness" but only a handful have realized any success.

(3) Timing

The timing of the selected strategy should be appropriate in two important ways:
(i) the length of time that will be necessary to implement the strategy should be appropriate. For example, a firm's cash flow position can be deteriorating faster than

its management's ability to retrench by collecting receivables, arranging a loan, or cutting expenses. (ii) The strategy must be timely in terms of environmental circumstances.

(4) Flexibility

The selected strategy should allow sufficient maneuverability so that management can respond to competitors' reactions and minor environmental changes while still maintaining the integrity of the strategy.

One way to build flexibility is to develop several contingency strategies, each of which applies to a somewhat different set of likely environmental assumptions. Then if the environmental assumptions begin to come true, the appropriate modifications can be made, having already been analyzed and pondered for their effects and requirements.

The same sort of contingency strategy set can be developed around likely competitor reactions.

(5) Management Commitment

The selected strategy should have the commitment of all levels of management. In some organizations top management's advocacy of a strategy will soon lead to its support. In others, actions for and against a strategy will develop. With such divisions, successful implementation of the strategy becomes difficult. Successful strategies require commitment, instead of just acceptance.

Commitment to a course of action is a function of the extent to which the strategy is perceived as satisfying (i) the need to justify past decisions (retrospective rationality), (ii) the need for consistency, and (iii) the need for prospective rationality. To generate maximum commitment, the selected strategy should confirm the correctness of decisions already made. Presumably managers at each level of the organization will react or proact to overall strategy with their own respective strategies.

Further, there are both cultural and organizational norms for consistency that apply to strategy selection as well as other decisions.

Some degree of consistency between the past strategy and the selected one is important in developing commitment because the similar new one demonstrates the correctness of the past one. This may at least partially explain why it tends to be difficult to get all the key factors in an organization to dedicate themselves to a radically new strategy. It may also explain why some board of directors seem to replace CEOs when they feel that a strategy change is necessary.

The higher the prospective rationality of the selection, the more commitment is facilitated. Prospective rationality is the product of the perceived probability of future outcomes and the perceived value of those outcomes. It is roughly equivalent to the expected value of the strategy. A manager who feels that the selected strategy has a high expected value will be more committed to it than one who feels the expected value is low.

Thus for commitment to develop, all participants should be convinced that the

organization has the resources, skills, time, and other attributes necessary to reach goals successfully with the new action plans, which together constitute a new strategy.

STRATEGIC PLANNING

Leaders are proactive. They make changes instead of reacting to change. The future requires corporate leadership with the skills to integrate many unexpected and seemingly diverse events into its planning. Every organization must plan for change in order to reach its ultimate goal. Effective planning helps an organization to adapt change by identifying opportunities and avoiding problems. It sets the direction for the other functions of management and for teamwork. Planning improves decision-making. All levels of management engage in planning.



Strategic planning refers to the process of developing and analyzing the organization's mission, overall goals, general strategies, and allocating resources. A strategy is a course of action created to achieve a long-term goal.

Examples of strategic planning includes planned growth rate in sales, mergers and acquisitions, diversification by technologies, types of products, customers and geographical areas, planning activities in the areas of organizing, staffing, finance, etc.

CHARACTERISTICS OF STRATEGIC PLANNING

The general attributes of strategic planning may be summarized as follows:

- (i) Strategic planning is a top management activity, i.e., top managers are actively involved in it.
- (ii) Top management gains commitment from other levels of managers to implement strategic planning, while the top management is committed to it.
- (iii) Strategic planning is a long range activity.
- (iv) It deals with basic and fundamental questions about the company's purpose, mission, objectives and goals, the customers, the method to reach the customers and the company's position in the market, its industry and society.
- (v) Strategic planning should clearly define where does the company stand and where should it go.
- (vi) It provides proper direction for operational planning and day-to-day strategic decisions.
- (vii) It enlightens the manager about the most consistent course of action available to him in the given situation and in the context of the company's strategy.
- (viii) Strategic planning inculcates a sense of coherence and momentum to an organization's action, decisions approaches and attitudes.

- (ix) It provides a sense of purpose and direction to both strategic planning and cohesion in operation.
- (x) It sets trends and direction for managerial actions.

Strategic planning produces fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does it. It requires broad-scale information gathering, an exploration of alternatives, and an emphasis on the future implications of present decisions. Top level managers engage chiefly in strategic planning or long range planning. They clarify the mission of the organization and set its goals. The input needed by top management for long range planning is summary reports about finances, operations, and the external environment.

The time length for strategies is arbitrary, but is probably two, three, or perhaps as many as five years. It is generally determined by how far in the future, the organization is committing its resources. Goals focus on desired changes. They are the ends that the organization strives to attain. Traditionally strategic planning has been done annually. However, many companies are doing away with annual business plans altogether and moving to a system of continuous planning, to permit quicker response to changing conditions. Thus, the strategic plan involves adapting the organization to take advantage of opportunities in its constantly changing environment.

The planning process is rational and amenable to the scientific approach to problem solving. It consists of a logical and orderly series of steps. Strategic planning sets the stage for the rest of the organization's planning. The tasks of the strategic planning process include:

- Define the mission.
- Conduct a situation or SWOT analysis by assessing strengths and weaknesses and identifying opportunities and threats.
- Set goals and objectives.
- Develop related strategies (tactical and operational).
- Monitor the plan.

Strategic planning refers to the process of deciding on objectives of the organization, on changes in these objectives, on the resources used to attain these objectives and on the policies that are to govern the acquisition, and disposition of these resources.

OPERATIONAL PLANNING

Operational planning refers to the process of deciding the most effective use of the resources already allocated and to develop a control mechanism to assure effective implementation of the actions so that organizational objectives are achieved. Operational planning thus includes adjustment of production, marketing and financial capacity of the organization to the expected level of operations, increasing the efficiency of operating, budgeting future costs, developing control over costs and efficiency etc.

Supervisors implement operational plans that are short-term and deal with the day-to-day work of their team. Short-term goals are aligned with the long-term goals

and can be achieved within one year. Supervisors set standards, form schedules, secure resources, and report progress. They need very detailed reports about operations, personnel, materials, and equipments. The supervisor interprets higher management plans as they apply to his or her unit. Thus, operational plans support tactical plans. They are the supervisor's tools for executing daily, weekly, and monthly activities.

For example, budget, which is a plan that shows how money will be spent over a certain period of time.

Other examples could be scheduling the work of employees and identifying needs for staff and resources to meet future changes. (Resources include employees, information, capital, facilities, machinery, equipment, supplies, and finances.)

Operational plans include policies, procedures, methods, and rules. The terms themselves imply different degrees of scope. A policy is a general statement designed to guide employees' actions in recurring situations. It establishes broad limits, provides direction, but permits some initiative and discretion on the part of the supervisor. Thus, policies are guidelines. A procedure is a sequence of steps or operations describing how to carry out an activity and usually involves a group. It is more specific than a policy and establishes a customary way of handling a recurring activity. Thus, less discretion on the part of the supervisor is permissible in its application.

A method sets up the manner and sequence of accomplishing a recurring, individual task. Almost no discretion is allowed. A rule is an established guide for conduct. Rules include definite things to do and not to do. There are no exceptions to the rules. Example of a rule is "No Smoking".

STRATEGIC PLANNING AND OPERATIONAL PLANNING

- (i) Strategic planning guides the choice among the broad directions in the organization and the general allocations of its managerial, financial and physical resources over future specified period of time. Operational planning focuses on the ways and means by which each of the individual functions may be programmed so that progress may be made towards the attainment of organizational objectives.
- (ii) Strategic planning takes into account the external environment and tries to relate the organization with it. It usually encompasses all the functional areas of the organization and is effected within the existing and long-term framework of economic, social, technical and political factors. Operational planning focuses on internal organizational environment so as to make the effective use of given resources.
- (iii) Strategic planning precedes the operational planning as the latter is primarily the implementation of the former. Since Strategic planning sets trends and direction for managerial actions, its time horizon is usually quite large, say, five years or so. Operational planning is concerned with short-term programmes implementing step by step progress towards basic organizational goals. Strategic planning is restricted by the practical limitations under which tactical planning operates.

- (iv) Strategic planning is usually conducted by top level management and other specified planning staff in the organization. At this level, people can take overall view of the organization and have necessary capability to relate the organization with the external environment. Operational planning is usually spread over a wide range within the organization and is generally performed by operating managers with the help of the subordinate staff.

COORDINATION OF STRATEGIC AND OPERATIONAL PLANNING

Some conflicts usually exists between strategic and operational planning. These may either be generated because of the different nature of two types of planning or because of the different groups of people involved in them. The common conflicts between strategic and operational planning are given below:

- (i) Strategic planners are more prone to change while operational planners may not relish changes.
- (ii) Another source of conflict between strategic and operational planning may be period of futurity. Strategic planners think in terms of long-term future of the organization, sometimes even at the cost of immediate gains. Strategic planners may think in terms of long-term profitability as new projects may affect short-term profitability adversely because of their long gestation period. While operational planners may concentrate more on near future.
- (iii) Strategic planning is likely to proceed at a more leisurely pace than operational planning. Operational planners focus on their present resources, have major day-to-day operating responsibilities and are under pressure to immediately accomplish a higher level of activity at lower cost. Under such circumstances, each group may exaggerate its importance in the organization and blending the two types of planning may become even more essential.

The above factors may lead to conflicts between strategic and operational planning. However, since operational planning contributes to strategic planning, it is essential that both are properly integrated.

TACTICAL PLANNING

Tactical plans have shorter time frames and narrower scopes than strategic plans. Tactical planning provides the specific ideas for implementing the strategic plan. It is the process of making detailed decisions about what to do, who will do it, and how to do it. Tactical planning is micro-oriented and focused on your short term goals, which usually have 1 to 18 months time frames. Tactical planning is contributory to strategic planning. This type of planning is mainly short-term oriented and made at lower levels and is all about how things are getting done. It is designed to apply and implement corporate strategy. The focus is on operations, which includes creating and executing effective and efficient action plans.

Areas that are covered in tactical planning include:

- (i) monthly or quarterly sales goals;
- (ii) improving customer service in specific areas;
- (iii) reducing the number of outside commitments; and

- (iv) creating action plans for strategic objectives, etc.

The following are the characteristics of tactical planning:

- (i) Tactical planning is formulated at supervisory or lower level of management who are supposed to take appropriate actions for solving operating problems.
- (ii) Tactical planning is short-term duration and directed at short-term actions.
- (iii) Tactical decisions are operational and people-oriented.
- (iv) Tactics are highly dynamic and innovative in approach.
- (v) Tactical decisions are the means designed to pursue specific ends or goals.
- (vi) Tactical planning is based on functional strategies.
- (vii) Tactics are subject to dynamics of administrative decisions concerning costs, time and resources.
- (viii) Tactical planning applies to all activities and it directly affects the implementation of functional strategies.

Broadly tactical planning covers the following:

- (i) Identifying and defining the tasks and sub-tasks required for the execution of policy and strategy.
- (ii) Deciding the sequence of activities in a task
- (iii) Specifying the performing units at every level which are responsible for the tasks.
- (iv) Defining the time limits for the accomplishment of each activity and task.
- (v) Specifying the costs of performing each task.
- (vi) Stating action plans to overcome personal resistance and administrative obstacles.

Management of tactical operations consists broadly of technical decision-making and tactical execution. Under technical decision-making, a set of operational objectives is laid down to guide tactical actions. In establishing tactical objectives the focus is on the sequential relationships between flexibilities in arrangement. Tactical execution involves actual actions to carry out tactical decisions. Tactical actions are restricted by its limitations of resources and time constraints. In considering the feasibility of tactical actions, the attention should be given on timing, impact and the choice of correct tactics. In tactical execution, the focus is on the operating level where the results are initially generated.

STRATEGIC PLANNING AND TACTICAL PLANNING

The following are the distinction between strategic planning and tactical planning:

- (i) Strategic planning is carried out at the highest level of management and is concerned with decisions in the pervue of that level. However, the tactical planning is related to lower level of management.

- (ii) Strategy formulation is a continuous but regular process. Tactics on the other hand are determined periodically with a fixed time schedule.
- (iii) Strategic decisions-making is influenced by personal values of executives while such values exercise little influence of tactical decision-making.
- (iv) In strategic formulation the total possible range of alternatives from which management must choose is greater than in tactical planning.
- (v) Strategic formulation and implementation managers have to deal with a high degree of uncertainty and the results of strategic decisions are not easily predictable. On the contrary, the dimension of tactical decisions is much shorter and the risks associated with such decisions can be assessed more easily.
- (vi) Strategic problems are generally unstructured and non-repetitive while tactical problems are structured and often repetitive in nature.
- (vii) Strategies are intended to last for long periods of time while tactics covers a shorter duration.
- (viii) Strategic formulation requires large amounts of information which is derived from the external environment while tactical decision-making requires internally generated data which is of historical nature.
- (ix) Strategy is original in the sense that it is the source for the origin or development of tactics. Tactics are formulated within and in pursuit of strategies.
- (x) In strategic formulation the number of people involved is less in contrast with tactical decision-making wherein large number of managers and workers are involved.
- (xi) The scope of strategies is usually broad and has fewer details than tactics.
- (xii) It is usually easier to measure the effectiveness and efficiency of tactics than of strategies. Result of strategic decisions are evident after a number of years while tactical results are quickly available and can easily be identified with specific actions.
- (xiii) Strategies are formulated from a corporate point of view whereas tactics are developed primarily from a functional view-point.

STRATEGIC DECISION MAKING

Strategic decision making is the core of strategic management. Strategic decision is a major choice of an action concerning committing of resources with a view to achieve organizational objectives. It has the following features:

- (i) Strategic decision is a major choice of action which affects the entire organization or major parts of it.
- (ii) It affects the long-term prosperity of the organization because the commitment is for long-term.
- (iii) It involves commitment of large amount of resources i.e., human, financial and physical in implementing the chosen strategic option.

- (iv) Because of high-level of futurity, a strategic decision is made after analyzing various factors both within the organization and its environment.
- (v) Since a strategic decision has major impact on the organization on long-term basis, it is made by top management which has much wider perspective of the organization and its environment.

Strategic decision making involves the usual decision-making process-specific objectives derived from organization's strategic intent, search for alternatives to achieve those objectives, evaluation of these alternatives and choice of the most appropriate alternative. Thereafter, this choice is put into action. Strategic choice cannot be taken without careful thought as to their implementation. It must be feasible as well as appropriate to the requirement of the situation.

After comparing possible strategies, the manager must decide which will be the future strategies of the organization. Many different decision models have been proposed to explain how these decisions can be made. The decision-making contexts constitute different frames of reference a decision maker might take. It is important to note which frame of reference or context surrounds a particular decision model and then to compare it only with other decision models within that context. The manager may actually select more than one model or strategy. In contingency planning systems, an action plan could be selected for the environmental scenario that is most likely to occur and/or the set of goals appropriate to that scenario. Another strategy would be selected for an optimistic scenario - a reasonable but very favorable set of environmental circumstances with a somewhat low probability of occurrence. Then a third strategy would be chosen for the pessimistic scenario, which also has a low probability of occurrence but carries unfavorable implications.

Decisions are described as—individual, group, organization, institutions and global. These are explained below:

(1) Individual Context

Many decision models focus on factors peculiar to the individual decision maker. The major ones based on the rationality, intuitive, and adaptive approaches.

(a) Rational Decision Model Approach: Under this model, the decision maker is a unique actor whose behaviour is rational and intelligent one. He is fully aware of all available feasible alternatives which maximize advantages. So, given the fixed scale of preferences, after considering all available alternatives in all respects, the decision maker chose the alternative that brings the maximum gain.

A decision is considered rational when it effectively and efficiently assures the achievement of aims for which the means are selected. A more general description is that rational decisions maximize net value achievement, where the sacrifice in one value necessitated by a decision is more than offset by an increase in the achievement of another value. Although many interpretations of rational decision making have been proposed that differ in their details, they tend to have the following common framework of basic steps:

- (i) Establishing a complete set of operational goals with weights.

- (ii) Preparing a complete inventory of values and resources with weights.
- (iii) Generating a complete set of strategy choices or solutions.
- (iv) Preparing a complete set of predicted benefits and costs of each strategy or solution choice.
- (v) Computing the expected value of each choice.
- (vi) Selecting the choice that has the highest expected value.

Completeness of these processes is important to ensure that one is behaving rationally. Stated differently, a decision maker could not lay claim to rationality where an incomplete set of strategy choices are selected for evaluation.

If the decision maker could perform each of these steps completely, then a decision that maximizes net value achievement would result.

Persons are assumed to make rational, maximizing decisions within closed systems in which minimum weight is given to the decision maker's environment and to the complexity of the decision process itself. Variables that cannot be computed within closed-system rationality requirements are disregarded by assuming all other things are equal. Then marginal analysis is used to calculate the profit-maximizing solution.

Experts criticized the above approach on the following grounds:

- (i) There is a wide divergence of interests, loyalties, and goals in organizations, so it is unlikely that the firm will achieve its objectives with anything resembling maximizing behavior. Thus the tendency is for managers to stop analyzing strategic alternatives when a suitable, but not maximum, choice is found.
- (ii) Objectively weighting organizational goals, even if they can be agreed upon, usually requires more information than most managers have. The most that can be expected is for the implications of alternative strategies to be imperfectly known. The cost of attempting to generate perfect information is usually prohibitive so that maximizing itself becomes non-rational.
- (iii) The decision makers are often not unique and have limited ability.

(b) Intuitive Approach: Another individual-based decision model is the intuitive anticipatory approach. Under this approach there are no explicit set of steps to follow. The managers make decisions based on common sense and experience about which strategy choice is the right one. Intuitive decisions generally apply within the short-term future and tend to entail little distant forecasting and planning. But this does not imply that managers make intuitive strategy selections in a void. Indeed such decisions typically come out of many years of management experience and a high level of confidence on the part of the decision maker.

The strategic decisions based on intuition are supported on the following grounds:

- (i) They are less time consuming;
- (ii) They provide opportunity to make the decision making ability a habit;

(iii) They have ready solutions to the problems.

Experts criticize this approach on the following grounds:

- One may not forget the danger that the decision may go wrong if base goes wrong.
- This approach unduly minimizes the importance of other bases of decision-making.
- This approach does not use all the tools available to decision-makers.

However, good instincts cannot be readily acquired without experience. The really effective and experienced people in both management and science typically operate in a largely intuitive manner and view with impatience attempts to make their methods explicit.

(c) *Adaptive Approach*: The essence of this approach is on taking strategic decisions on the basis of how a change is perceived at a given point of time. With the changing circumstances, the decisions are also reviewed. Circumstances are spelt out in terms of environment. If an environment is perceived to be stable, strategic decisions are based on certainty, in case it is less stable and future is risky, contingency planning system are adopted and in uncertain environment, the emphasis is on building up adaptive strategy to respond to changes as and when they occur. An off proposes this approach as a way to apply probability estimates to the process of selecting strategy. It basically includes the following steps:

- Determine minimum threshold values for each goal. These are the minimum acceptable values of variables pertinent to goals.
- Apply threshold minimums to strategy choices and reject those strategies which are not expected to reach the minimums.
- Rank the strategy choices in terms of their ability to reach specified goal values.
- Assign the probability of reaching each goal to remaining strategies assessed according to the extent to which they can be affected by expected environmental occurrences. The analyst would have already developed a data set. This step involves linking the data set to the strategy choices by use of either subjective or objective probabilities.
- Compute the expected value of each strategy choice which remains in the analysis by finding the products of its feasibility estimate and its payoff.
- Select the strategy with the greatest expected value. When several strategies produce similar expected values, they can all be referred for subsequent analysis or selection according to other criteria.

This approach results in adapting or changing one's strategy depending upon the way existing circumstances are perceived. As one proceeds through the adaptive process, certain rankings, payoffs, and probabilities can result in removing strategies from further consideration, modifying remaining strategies, or creating new strategies.

(2) Group Context

Although business decisions ultimately are made by individuals, decision models

within the group context focus on collections of people as the major influence in decisions-making. These approaches are group and elite models.

(a) *Group Model*: This model views strategy selection as a process of balancing the interests of groups. Thus, the strategy selected from the various strategy choices represents a compromise among the proponents of those strategy choices.

Although group theory, applies to public policy, a CEO intent on balancing internal group influences in strategy selection would also utilize such an approach. Balancing the interests of external groups in strategy selection can also be viewed as a group equilibrium problem. When the relative power of groups changes, strategy will change to establish a new equilibrium. Strategy will move in the direction desired by the groups gaining in influence and away from the desires of groups losing influence.

(b) *Elite Theory*: Elites actually shape mass opinion on policy questions more than masses shape elite opinion. Thus, public policy really turns out to be the preferences of elites. Public officials and administrators merely carry out the policies decided upon by the elite. Policies flow downward from elites to masses, they do not arise from mass demands.

In a situation, management often emerges as the dominant coalition in a situation, when the number of people or groups competing for power becomes large and power is widely dispersed. Under this situation the odds are against one individual or group being able to control management, so seldom does such an attempt occur. Thus, relative to the perhaps hundreds of thousands of owners of a large, publicly owned corporation, management can constitute an effective elite. Management's decision and strategy selections can be largely implemented unilaterally. The elite group may come to view the mass of owners as passive, apathetic, ill-informed, and subject to manipulation. Preservation of the organization is seen by members of the elite as the way to perpetuate their own positions, autonomy, and wealth. This goal congruence between the elite and the mass of owners can be constructive.

Of course, the elite model can apply more neatly to public organizations than to private. A public university can be dominated by a state legislature, a board of trustees, a union or an administrative group, which allows faculty members to think that they are making strategic decisions when in fact they are not.

(3) Organization Context

In this case attention is focused on the organization itself. Easton explains, the systems model as a descriptive model of public policy making. It has been used repeatedly as a conceptualization for all sorts of business decisions. Two prominent models in this context are explained as under:

(a) *Systems Model*: Systems model portrays decision making primarily as a function of a set of inputs, both organizational and external in origin, which, when processed by the organization, lead to a particular set of outputs. It addresses the organizational related decisions and can be used to analyze them by comparing inputs and outputs across organizations. In this case, outputs can be analyzed as a function of organizational inputs. Stated differently, strategy can be viewed as the dependent variable in analysis with organizational inputs treated as independent variables. Thus, a systems-oriented strategist might look at past environmental

scenarios and company circumstances and identify ones similar to the present. Then, the strategy which worked best during past situations that are similar to the present would be selected for implementation. As such, the systems model pays little attention to the internal machinations of the decision process itself, focusing instead on the relationships between inputs and outputs.

The major benefit of this approach is that historical analysis of relationships between inputs of the organization or to the decision-making process and the characteristics of strategies associated with those inputs can be used to spot patterns with normative implications.

(b) *Organizational Process Model*: Another organizational context model of decision making is organizational process model. Fundamentally strategy would be selected according to this model by: (1) inter-organizational bargaining; (2) agreement on goals; (3) informal formulation of expectations, and (4) selection of the first strategy choice. Strategy would be selected according to the political interplay among the various internal and external coalitions of the organization.

(4) Institutional Context

Under this, institutions are seen as the primary factors influencing strategy selection. In the public policy area political activities generally center about particular governmental institutions, courts, states, municipalities, etc. The interests of individuals and groups, and their activities on behalf of these interests, are generally directed towards governmental institutions. Public policy is authoritatively determined, implemented, and enforced by governmental institutions.

Basically, the institutional model seeks to explain the nature of institutional influence on public policy making. A policy in government is not implemented and enforced until it has been adopted by a governmental institution.

Most institutional studies in government have described the organization structure, duties, and functions of institutions. The point of studying public policy within the institutional model is to analyze the relationships between these institutional variables and the content of public policy. With reference to such institutional strategy analysis, patterns of past relationships can shed light on the problem of strategy selection choices.

(5) Global Context

Strategic decisions are undertaken by the organization at global level also to optimize their objectives in the given circumstances. At present no such model exists. A strategy selection model will emerge in the near future that casts the selection decision within a global context. However, work has been done that describes how to take global factors into consideration in the process of strategy formulation.

The global influences enter strategy formulation through the structured analysis of competition in global industries. Global industries are those in which the strategic positions of competitors in major geographical or national markets are fundamentally affected by their overall global positions. Organizations which have multinational subsidiaries can be non-global if their subsidiaries compete only within, instead of between, countries.

Effective global strategy establishes the competitive advantage for an organization in terms of the following four factors:



- Differences among countries in the cost of production;
- Demographic differences among foreign markets;
- Different roles of foreign governments in the competitive system;
- Cross-country differences in goals, resources and ability to monitor foreign competitors.

The major variables addressed in structural analysis of competition i.e., suppliers, potential entrants, buyers, substitutes, and competitors etc., remain the same for global industry analysis and strategy formulation as for domestic industry analysis. However, the scope of each variable is greater for global than for domestic industries. Consequently structural analysis in global industries must encompass foreign competitors, a wider pool of potential entrants, a broader array of possible substitutes, and increased possibilities that firms' goals and personalities will differ as well as their perceptions of what is strategically important.

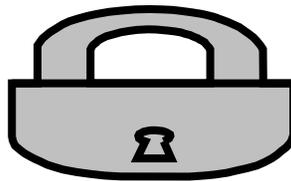
LESSON ROUND UP



- Vision basically refers to mental perception of the kind of environment that an organization aspires to create with a broad time frame. Any organization forms its vision and mission in light of the information and insight gained from studying its internal and external environments.
- Mission is a general statement of what distinguishes the organization from all other of its types.
- Vision and mission provide direction to the firm and signals important descriptive information to stakeholders.
- Setting up the organization's goal or objective is the starting point in strategic management.
- A goal or objective consists of a projected state of affairs which a person or a system plans or intends to achieve or bring about — a personal or organizational desired end-point in some sort of assumed development. Objectives and goals are more precise than vision and mission.

- To achieve the objectives, the organization has to follow a strategy or a set of strategies. The strategies can broadly be offensive strategies, focus strategies, integration strategies, diversification strategies, defensive strategies etc.
- Offensive types of strategies include concentration postures, market penetration, market development, product development, horizontal merger, niching-lower cost, differentiation, integration and diversification strategies etc.
- Defensive types of strategies include retrenchment, divestment, liquidation etc.
- After identifying a number of strategic alternatives these need to be compared to find the most suitable one. For this purpose growth share matrix (GSM), GE/McKinsey Matrix and Life cycle approach are popularly used.
- Any strategy to get selected must be timely, flexible, and consistent with the organizational goals and have commitment of the top management.
- Successful organizations effectively use strategic and tactical planning both. Strategic planning produces fundamental decisions and actions that shape and guide the organization's future. It requires broad-scale information gathering, an exploration of alternatives, and an emphasis on the future implications of present decisions. On the other hand, tactical plans have shorter time frames and narrower scopes than strategic plans and provide specific ideas for implementing the strategic plan.
- Operational planning is the process of deciding the effective use of resources already allocated. It includes marketing and financial capacity, increasing the efficiency of operating and budgeting future costs etc.
- After comparing possible strategies, the manager must decide which will be the future strategy of the organization. A number of models for optimal decision making have been proposed in individual, group, organization, and global context.

SELF TEST QUESTIONS

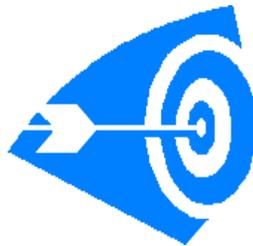


1. What is a 'mission'? Why is it necessary as a starting point in the process of strategic management?
2. What circumstances require a change or modification in mission?
3. What are 'objectives'? Why do firms have objectives?
4. Explain how objectives and goals differ in their dimensions.
5. "General objectives and specific objectives have different perception". Explain.
6. Explain the different offensive and defensive strategies.
7. Explain the various methods of integration strategies.
8. Explain the rationale of diversification and integration?

9. How do you evaluate the strategic alternatives?
 10. Explain the BCG matrix model for evaluation of strategic alternatives.
 11. Explain the different stages of product life cycle.
 12. Discuss and distinguish between strategic planning and tactical planning.
 13. Discuss the role of life cycle analysis in choosing a strategic alternative.
 14. "Strategic planning is different from operational planning ". Discuss.
 15. "Strategic decision making is the core of management". Explain the various types of decisions used.
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STUDY IV IMPLEMENTATION AND CONTROL

LEARNING OBJECTIVES



The object of this study lesson is to enable the students to:

- Explain the concepts of strategy implementation
- Understand the techniques of strategic formulation and implementation
- Summarise factors in strategic implementation
- Conceptualise various issues in strategic implementation
- Develop McKinsey 7-S Framework
- Understand the activate strategies
- Explain enforcement of structural implementation
- Formalize various forms of organizational structure
- Understand the procedural requirements in holding strategic implementation process
- Narrate the issues relevant for implementation of behavioral strategy
- Formulate functional strategies
- Explain the techniques of strategic programming, budget and procedures
- Formulize strategic control process
- Explain the strategic control techniques
- Narrate the issues in strategic change management.

CONCEPTS OF STRATEGY IMPLEMENTATION

Strategy implementation is a process through which a chosen strategy is put into action. Strategies are only a means to an end i.e., accomplishment of organizations' objectives which have to be activated through implementation. This is because both strategic formulation and strategic implementation process are intervened in real life situation. Strategy formulation and implementation are interrelated though skills and levels of skills are different. The relationship between the two can be better understood in terms of forward and backward linkages. A good strategy without effective implementation is futile for success of an organization.

The implementation of policies and strategies is concerned with the design and management of systems to achieve the best integration of people, structures,

processes and resources in reaching organization objectives. Strategy implementation may also consist of securing resources, organizing these resources and directing the use of these resources within and outside the organization. In an action, the strategy chosen is a promise and implementation is to turn the promise into performance. These tasks of transformation warrant structural and administrative mechanism which can be compatible and workable to be established to reinforce the chosen strategic direction for action. Once the strategy has been determined; it is the job of the management to ensure that the strategy is implemented. The major task of implementation strategy is to create a fit between the company goals and its other activities. Generally two types of fits needs to be created—(i) fits between the strategy and functional policies; and (ii) fits between the strategy and the organizational structure, process and systems.

Developing alternative strategy and making the strategic choice constitute important steps in the process of strategic management. Implementation of the strategy is a vital step in the process. A good strategy without effective implementation can hardly be expected to succeed in the performance. Implementation of strategy in an organization covers a number of inter-related decisions, choices, and a broad range of activities such as the commitments and cooperation of all units, sections and departments. There are two inter-related tasks involved in the process, i.e. differentiation and integration.

The differentiation is related with segmentation of total strategic plan into various components i.e. the sub-unit goals and other plans of the activities to be carried on by divisions, departments and units. The organization units must be assigned their task, activities and roles so as to provide a clear understanding of the responsibility for each part of the strategic plan. Translating strategic goals into operating plans and activities is an integral part of differentiation. In addition to the differentiation of activities, it is necessary that management should coordinate and integrate the diverse activities into a unified and cohesive effort. Integration of functions and programs among organization units over time is a task system which is concerned with unifying the diverse segments of activity on sub goals in conformity with the strategic goals of the organization as a whole. Integration is required at the following three levels:

- (i) At the functional level of each business units i.e. production, marketing etc.,
- (ii) At the business or product level coordinating the various business units.
- (iii) At the corporate level where each of the major business plans must be integrated into a total system strategy.

Planning for implementation for strategy is the process of developing goals and activities for various levels of the organization.

STRATEGY FORMULATION AND IMPLEMENTATION



Strategy formulation is largely an intellectual process whereas strategy implementation is more operational in character. Strategy formulation requires good conceptual, integrative and analytical skills but strategy implementation requires special skills in motivating and managing others.

Strategy formulation occurs primarily at the corporate level of an organization while strategy implementation permeates all hierarchy levels. In fact, they are not supplanting each other but supplementing each other. In other words, they are not conflicting but contemporary to each other. The relation between strategy formulation and implementation can be best understood by their inter-dependence. There are two types of linkages between strategy formulation and implementation i.e. forward linkage and backward linkage.

Forward linkage is concerned with the influence of the formulation on implementation. Strategy formulation has forward linkage with implementation in the sense that total implementation activities are geared according to strategy chosen for implementation. The nature and type of organizational processes and systems are conditioned by the strategy for its successful implementation. Thus, implementation is dependent upon formulation.

Backward linkage, on the other hand, deals with the influence in the opposite direction. Strategy formulation has backward linkage with implementation as organization tends to adopt those strategies which can be implemented with the help of existing structure of resources joined with some additional efforts. The strategy is formulated in a particular environment which is dynamic. The feedback from operations, a result of strategy implementation gives notices of the changing environmental factors to which strategy should be seen in continuity rather than in discrete form.

The inter-dependence of formulation and implementation of strategy does not mean that managers are not to distinguish between the two. While interdependence helps management to take corrective action in the light of the feedback given by the implementation, the distinction between the two helps in putting right prospective on organizational resources both human and physical. When the strategy is put into action through the process of developing internal plans, the feedback mechanism stress the need to continually assess implementation of strategy and organizational performance in order to determine any change in the strategy. Thus, those who are responsible for strategy formulation are also responsible for its implementation.

STRATEGY IMPLEMENTATION—SUPPORTING FACTORS

The development and selection of strategies to pursue in an organization is considered easier and less time consuming than implementing these strategies once they have been chosen. An effective implementation of strategy in an organization needs multiple supporting factors. Some of these factors include the following:

(i) Action Planning

Organizations to be successful in strategy implementation need to develop a detailed action plan i.e., chronological lists of action steps (tactics) which add the necessary detail to strategies and assign responsibility to specific individual or group for accomplishing those actions. They should also set a due date and estimate the resources required to accomplish each of their action steps. Thus, they translate their broad strategy statement into a number of specific work assignments.

(ii) Organizational Structure

Successful strategists should also give proper thought to their organizational

structure and see whether the current structure is appropriate for their intended strategy because different structures suit the implementation of different strategies

(iii) Human Resource Factors

Human Resource factors through framing strategic plan play a vital role in successful implementation of strategies in an organization. Strategist realize that the human resource issue is really a two part story. The consideration of human resources requires the management to think about the organization's communication needs. Further, managers successful at implementation are aware of the effects each new strategy will have on their human resource needs.

(iv) Annual Business Plan

Organizations successful at implementation are well aware of their need to fund their intended strategies. They think about necessary financial commitment in the planning process. For firming up their commitments to strategic plans, companies monetize their strategy. That way, they link their strategic plan to their annual business plan.

(v) Monitoring and Control

Monitoring and controlling the plan covers a list of options to get back on course if company should veer off. Those options include changing the schedule, changing the action steps, changing the strategy or changing the objective.

Developing an effective strategic plan is only half the battle. Getting it implemented is the other half — completing the tactics to accomplish the strategies and objectives within the plan. Monitoring the implementation of strategic plan is justified on the following grounds:

- (i) It helps to assure the organization efforts conform to the plan.
- (ii) It enables the organization to ensure that the results achieved correspond to our quantified objectives.
- (iii) Further monitoring allows for corrective action.
- (iv) Since monitoring is part of control process, it encourages improved performance.
- (v) Monitoring provides the essential link between the written plan and the day-to-day operation of the business.

It demonstrates to all that organization is really managing the business according to its strategic plan.

Further, many organizations put together the above five supports for implementing the strategy. They develop action plans, consider organizational structure, take a close look at their human resource needs, fund their strategies through their annual business plan, and develop a plan to monitor and control the accomplishment of their strategies and tactics. And yet they still fail to successfully implement those strategies and tactics. The reason, most often, is they lack linkage. Linkage is simply the tying together of all the activities of the organization to make sure that all of the organizational resources are rowing in the same direction.

It isn't enough to manage one, two or a few strategy supporting factors. To successfully implement your strategies, you've got to manage them all. And make sure you link them together.

Strategies require "linkage" both vertically and horizontally. Vertical linkages establish coordination and support between corporate, divisional and departmental plans. A divisional strategy calling for development of a new product should be driven by a corporate objective i.e. growth and on a knowledge of available resources, capital resources available from corporate as well as human and technological resources in the R&D department.

Linkages which are horizontal across departments, across regional offices, across manufacturing plants or divisions, require coordination and cooperation to get the organizational units "all playing in harmony." For example, a strategy calling for introduction of a new product requires the combined efforts of and coordination and cooperation among R&D, marketing, and the manufacturing departments.

To set functional area goals, the following steps should be taken:

1. For each functional area, compare present functional goals with new enterprise, corporate and business-level goals.
2. Decide what new goal areas (functional variables) are needed for each function.
3. Set new goal levels (values for each functional area's variables).

ISSUES IN STRATEGY IMPLEMENTATION

An organization is confronted with a number of issues in the process of strategy implementation. Some of the important issues are discussed as follows:

(i) Project implementation

Project is a highly specific program for which time schedule and specific cause are determined in advance. Projects create all necessary conditions and facilities required for the strategy implementation, the discipline of project management. A project basically passes through various phases which are given below before a set of task can be accomplished:

- (a) Detailed planning related to different aspects of projects such as infrastructure design, schedules, budgets etc., has to be completed.
- (b) Ideas generated during the process of strategic alternatives and choice consideration form the core of the future projects that may be undertaken by the organization.
- (c) After a set of projects have been identified and arranged according to the priority, they have to be subjected to preliminary project analysis pertaining to technical, financial, marketing and economic aspects. After the screening, the viable projects are taken up and feasibility studies are conducted.
- (d) Detailed engineering, awarding contracts, civil and other types of

construction etc., are to be undertaken during the implementation phase leading to the testing trail and commissioning of the plant.

(e) The final phase deals with disbanding the project.

(ii) Procedural implementation

Strategy implementation also requires executing the strategy based on the rules, regulations and procedures formulated by the Government. Though many procedures are simplified with the liberalization, privatization, and globalization of the Indian economy, certain procedures are still applicable in the process of strategic implementation such as, licensing requirements, Foreign Exchange Management Act requirements, collaboration procedures, import and export requirements, incentives and benefits, requirements of Labour Laws and other Legislations.

(iii) Organisational Structure and Strategies

Organizational structure is a means for achieving organization mission and objectives. Thus, it is an important source of strategic implementation.



Organizational structure refers to the method of allocating duties and responsibilities to individuals, and the ways these individuals are grouped together into units, departments and divisions.

Companies form structures for their organizations based on their strategies. There are number of methods in which the organizations can be structured. A simple strategy requires simple structure where as the growth strategies require a flexible structure and complex strategies to build the matrix structures.

(iv) Resource Allocation

Resource allocation involves the process of allocating organizational resources to various divisions, departments and strategic business units. It deals with the procurement, commitment and financing the physical and the human resources required to accomplish strategic tasks for the achievement of organizational objectives.

(v) Functional Policies

Functional policies describes functional guidelines to operating managers so that coordination across functional units can take place. Once the strategy of the companies is decided, modificational functional policies may become necessary to meet the demands of the new business.

(vi) Communication Strategy

Communication strategy covering the mission, objectives, market scope, technology and all the issues related to implementation, to different levels in the organization is very important for its success. This is because strategy is implemented through people who ought to be clear about their roles they have to play in relation to each other.

(vii) Leadership

Appropriate leadership is necessary for developing effective structure and systems for the success of strategy. Leadership is the key factor for developing and maintaining right culture and climate in the organization.

(viii) Challenges to Change

The strategy implementation process generally involves a change. The change can be minor or major. The process of change may cover infreezing, moving and refreezing.

(ix) Pre-implementation Evaluation Strategy

Before the implementation of the strategy, it is advisable to go for a final scrutiny so as to avoid failure due to weaknesses in the analysis, if any and to ensure that the strategy decided for the organization is optimum.

Illustration:***WalMart's Approach to Strategy implementation with regard to "Standards for Suppliers"***

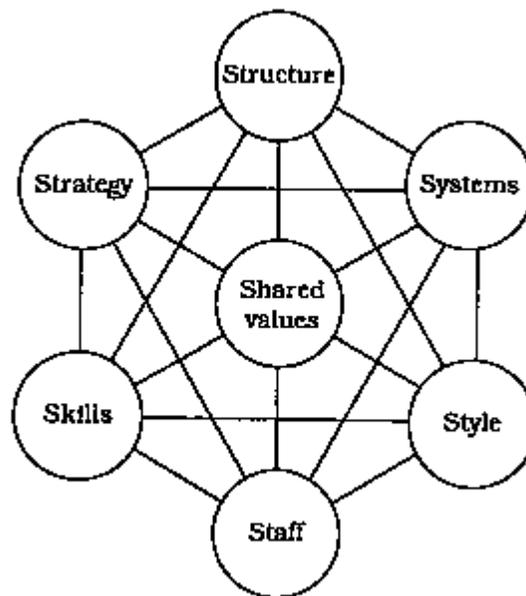
During the 1990s, WalMart began establishing standards for its foreign suppliers particularly those having a history of problematic wages and working conditions. This has been done to make the suppliers practice compatible with the standards established by Wal-Mart. The object behind execution of this strategy was Wal-Mart's concern for its reputation with customers and shareholders which could be affected due to divergent practices adopted by its suppliers. Not only has Wal-Mart established a set of suppliers standards but has also established standards to monitor compliance therewith by the foreign suppliers. Wal-Mart has set up factory certification teams based in Dubai, Singapore, India & China to monitor foreign factory compliance with company supplier standards.

Source: Crafting and Executing Strategy: Concepts & Cases: Thomson, Arthur. A et. al

McKINSEYS 7-S FRAMEWORK

McKinsey developed the 7-S framework management model which organize seven factors to organize a company in a holistic and an effective way with the objective to diagnose the causes of organization problem and formulate program for improvement due to the implementation of the strategy which are associated with change in the organization.

The organizational change is not simply a matter of structure although the structure is a significant variable in the management change. Effective organizational change may be understood to be a complex relationship between the 7-S i.e. strategy, structure, systems, style, skills, staff and shared values (super ordinate goals). The relationship is diagrammatically presented as follows:



McKinsey 7 Framework

The above framework shows that there are a multiplicity of factors which influence an organization's ability to change and understand as to how the 7-S model mechanism works. It is imperative to know what each 'S' means and what is its implication. The 3S's across the top of the model are described as Hard S's and 4S's across the bottom of the model are less tangible, more cultural in nature and some time neglected in major change efforts and mergers and were termed as soft Ss by McKinsey.

(i) Strategy

Strategy means to achieve objectives. It provides the direction and the scope of the organization over the long-term. Strategy refers to actions the organization plans or undertakes in response to or in anticipation of external environment. It includes purposes, missions, objectives, goals and major action plans and policies. A strategy targets at gaining competitive advantage over rivals.

(ii) Structure

It is a basic framework to designate responsibilities and functions. Organization structures prefers relatively more durable organizational arrangements and relationship. It prescribes the formal relationship among various positions and activities. Organizational structure performs the following functions:

- (a) Dividing the whole organization into activities, departments, setting division of labour and delegation of authority.
- (b) Facilitating coordination and control of various activities in the framework of organizational mission, purposes and goals.

- (c) Reduction of uncertainty through forecasting research and planning in the organization.
- (d) Prediction of future and designing the future course of action.

(iii) System

It is a management tool for planning, decision-making, communication control and the procedures and processes regularly followed by an organization. Systems in the 7-S framework signifies all the rules and regulations, procedures both formal and informal that complement the organizational structure. It includes production, planning and control system, budgeting and budgetary control system, financial and cost account system, training and development system, performance evaluation system and so on. Change in a strategy is implemented through changes in the system.

(iv) Style

Style stands for the patterns of behaviour and managerial style of top management over a period of time. It is visible through relationship among the three levels of management or managers, organizational culture which is a reflection of value system. The style has to change with the change in strategy, system and structure.

(v) Staff

It is the human resources of the organization i.e., the kind of specialties or professions represented in an organization such as engineers, specialist in different areas: finance, personnel, legal etc. Staffing is the process of recruiting and selecting persons for the organization, training and developing them, placing them in their post so as to reap the potential from each of them. According to 7-S framework the term 'staff' refers to the way organizations introduce young recruits into the main streams of their activities and the manner in which they manage their careers as the new entrants develop into future managers.

(vi) Skills

It means organization and individual capabilities. Skill is an ability or proficiency in performing a particular task. It includes those characteristics which most people use to describe a company. Skills are developed over a period of time and as a result of interaction of a number of factors, performing certain tasks successfully over a period of time, kind of people in the organization, top management style, the organizational structure, the external influences etc. Skills are the dominant capabilities and competencies possessed by the organization through its people.

(vii) Shared Values (Super-ordinate Goals)

Super-ordinate goals stands for company's mission, vision, values, philosophy in the backdrop of which organizational goals and objectives are set and strategies are formulated. It's a set of values and aspirations that goes beyond a conventional formal statement of corporate objectives. These are essential as they inspire the members of the organization and provide a definite direction to its operations.

Some of the important benefits of McKinsey's 7-S Framework Model are as follows:

- (i) It is a diagnostic tool for understanding the organization which are non-effective.
- (ii) It helps to guide organization change.
- (iii) It combines rational and hard elements with emotional and soft elements;
- (iv) Managers must act on all Ss in parallel and all S's are interrelated.

McKinsey framework shows that there is a multiplicity of factors which influence an organization's ability to change. Comment.

It is correct. McKinsey developed the 7-S framework management model which organize seven factors to organize a company in an holistic and effective way with the objective to diagnose the causes of organization problem and formulate program for improvement due to the implementation of the strategy which are associated with change in the organization.



The framework rests on the proposition that effective organizational change is best understood in terms of the complex relationship between strategy, structure, systems, style, skills, staff and shared values (super ordinate goals)- the seven S's.

According to the framework, there is a multiplicity of factors which influence an organization's ability to change and understand as to how the 7-S model mechanism works. In general terms, the proposition of the 7-S model suggests that there are multiple factors which influence an organization's ability to change and its proper mode of change. Since the variables are interconnected, significant progress cannot be made in one area unless corresponding progress is made in other areas too. It is imperative to know what each 'S' means and what is its implication. The 3S's across the top of the model are described as Hard S's and 4S's across the bottom of the model are less tangible, more cultural in nature and some time neglected in major change efforts and mergers and were termed as soft Ss by McKinsey.

ACTIVATING STRATEGY

Activation is the process of stimulating an activity so that it can be performed successfully. Activation of strategy is required because only a small number of people are involved in the strategy formulation while its implementation involves a good number of people within the organization. Activation of strategies requires the performance of the following activities:

(i) Institutionalization of strategy

Strategists role in the implementation of strategy is its institutionalization. A

successful implementation of strategy requires that the manager should act as its promoter or defender. Institutionalization of strategy involves the following two elements:

- (a) *Strategy Communication*: The role of the strategists is to make the fundamental, analytical and entrepreneurial decisions and present these to the members of the organization to bring their support. Therefore, in order to get the strategy accepted and consequently effectively implemented requires proper communication. The form of communication may be oral through interaction among strategists and other persons. However, in large organizations oral communication may not be adequate. Hence, a well documented written form of communication is followed.
- (b) *Strategy Acceptance*: Strategy acceptance makes organizational members to develop a positive attitude towards the strategy. This facilitates them to make commitment to strategy by treating it as their own strategy than imposed by others. Creation of such feeling is essential for the effective implementation of the strategy.

(ii) Formulation of Action Plans and Programs

Once the strategy is institutionalized, the organization may proceed to formulate action plans and programs. Action plans are the targets for the effective utilization of resources in an organization so as to achieve the set objectives. It may be plan for procuring a new plant, developing a new product, etc. The action plans to be formulated in the organization depend upon the nature of the strategy under implementation. Against action plans, a program is a single use plan which covers relatively a large set of activities and specifies major steps, in their order and timing, and responsibility for each step. Programs are generally supported by necessary capital and operating budgets. Since there may be various programs involved in the implementation of strategy, these should be coordinated so that each of them contributes positively to others.

(iii) Translating General Objectives into Specific Objectives

Some times objectives are too general and intangible to be transformed into action. In order to make these objectives operational, managers determine specific objectives within the framework of general objectives which the organization and its various departments will seek to achieve within a particular period. A specific objective provides focus on the activities that may be undertaken to achieve the overall growth of the organization. Translation of general objectives in the specific and operative objectives must fulfill the following criteria:

- (a) It should be tangible, meaningful and easily measurable as organizational performance; and
- (b) It should contribute to the achievement of the general objectives.

(iv) Resource Mobilization and Allocation

In order to implement a strategy, an organization should have resources i.e., financial or human and these resources should be committed and allocated to

various units to have maximum utilization. Financial resources are the means by which an organization produces goods and services. These resources are used to procure various physical resources such as land, building, machinery, raw material, etc. An organization should concentrate on mobilization of the required resources and their allocation among various units and departments.

Resource mobilization process involves procurement of resources which may be required to implement a strategy. The amount of resources are determined on the basis of nature and type of strategy. An organization's capacity to mobilize resources has inverse relationship with strategy. A strategy determines what type of resources will be required while resource mobilization capacity determines what type of strategy will be selected. Resources can be owned, leased or rented. Once the resources are mobilized, resource allocation of activity is undertaken. It involves allocation of different resources, financial and human among various organization units and departments. Resource allocation implies that when resources are committed to a unit or a project, the organization takes a risk which depends upon the time taken to recover the cost of resources.

Some of the problems which are encountered in the process of resource allocation are as follows:

- (i) *Power play*: In an organization each and every department tries to have larger share of the resources at its disposal. The department feels relatively stronger than others if it has more resources than other departments. Further, each department wants to have more flexibility in operations in order to hide its inefficiency.
- (ii) *Commitments of past*: Past commitment on the part of the organization with regard to resource which acts as a hurdle in the optimal resource allocation, unless it is not sorted out and settled. The managers in-charge of departments where the resources are not used properly opposes the transfer of resources as they feel that they are neglected.
- (iii) *Resistance to changes*: The organization may turn resistance to change even though it is a loser under changing circumstances because of false ideology. The organization put best managers to manage a product which are fast declining because of false prestige and sentimental ways of approach. Sometimes organizations want to capitalize on the past glory and their hold over larger resources even though other areas are much more profitable.

STRUCTURAL IMPLEMENTATION

Structural implementation involves the designing of organizational structure and interlinking various departments and units of the organization created as a result of the organizational structure. Organizational structure is a pattern in which the various parts of the organization are interrelated or interconnected. It involves how the organization will be divided and assigned among various positions, groups, departments, divisions etc., and the coordination necessary to accomplish organizational objectives. The structure defines the framework within which the activities work. When structuring an organization, the management needs to consider

such aspects as departmentalization, level of authority, specialization, supervision, centralization, decentralization, size of departments, grouping of activities, extent and nature of delegation etc. There are two aspects of organization design i.e.: (i) differentiation; and (ii) integration.

There should be close relationship between an organization strategy and its structure. The organization structure is designed according to the needs of the strategy. Relationship between strategy and structure can be related in terms of utilizing structure for strategy implementation as structure is a means to an end and not an end in itself. Recognition of interaction between strategy and structure is crucial for a complete understanding of the criteria which underlie the structural design. It becomes clear that a top management's perspective in structural design is necessary when one understands that such a design is a result of overall strategy and the success of the strategy is also dependent on that desire. Organization's structure must be flexible and capable of quick adjustments in case of environment changes.



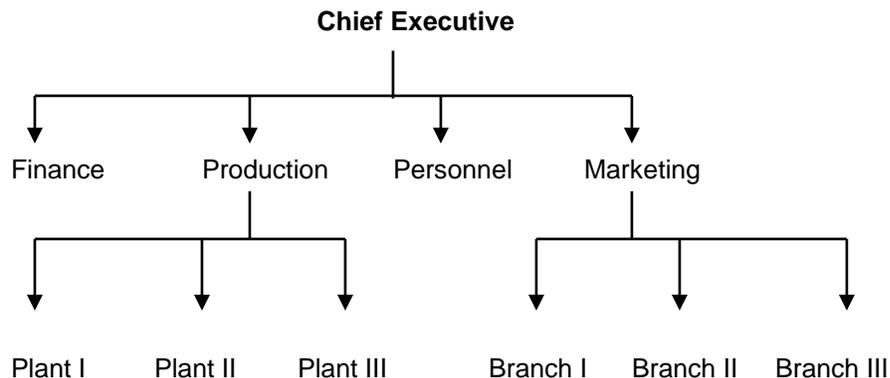
Structure of an organization can influence its strategy formulation process. It is because organization's structural form (line and staff, matrix, market or product differentiation etc.) can affect internal communication, interpersonal relations and other strategic perspectives. Companies with organization system based on advanced information technology can use the latest IT trends to support and hence influence the strategy formulation.

FORMS OF ORGANISATION STRUCTURE

There are two basic forms of organization structures available for large organizations i.e. functional structure and divisional structure. These forms can further be supplemented by additional prescriptions which may result in the form of matrix organization, free-form organization, etc.

Functional Structure

Functional structure is created by grouping the activities on the basis of functions required for implementing strategy. The basic functions are those which are essential for the strategy and their operations contribute to organizational efficiency which includes production, marketing, finance, personnel, etc. When the departments are created on the basis of basic functions and the manager feels that this span of management is too wide to manage effectively which invariably happens in large organizations, several departments are created on the basis of dividing a basic function into sub functions. For example a marketing department may be classified into advertising, sales, research etc. Thus, the process of functional differentiation would continue through successive levels in the hierarchy. Following is a form of functional structure:



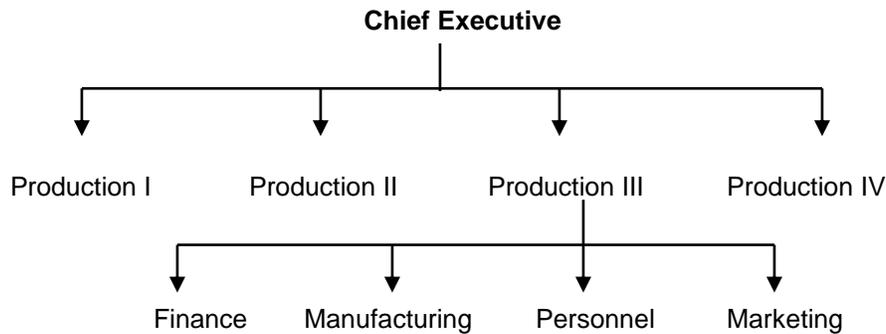
The functional structure is based on specialization of functions. This leads to economies of scale and specialization which increases operational efficiency and organization efficiency, economic flexibility and greater motivation to the people having attached to their area of speciality. The structure is suitable to firms operating single or related business. There are certain limitations of this form of organization structure due to the following reasons:

- (i) *Lack of responsibility*: No one in the organization is responsible for the project cost and profit. There is always lack of coordination and control because functional department managers are expected to discharge their responsibility within the budget.
- (ii) *Complex activity*: Complex and different activity in the organization require faster decision-making due to time factor which is of prime importance. Functional structure provides slow decision making process because the problem requiring a decision has to pass through various departments and all of them may have a divergent view on the matter. This process often delays important decisions and thus organization has to incur additional cost or loose the opportunity.
- (iii) *Lack of responsiveness*: Functional structure lacks responsiveness necessary to cope with new and rapidly changing work requirements.
- (iv) *Line and staff conflicts*: Functional structure suffers from usual line and staff conflicts, interdepartmental conflicts and other weaknesses emerging from such a structure. The degree of such conflicts is positive; they may often be affected specially in the absence of proper coordination.

(ii) Divisional Structure

In divisional structure, the activities are grouped according to the types of products manufactured or different market territories as the organizations began to grow by expanding variety of functions performed. The organizational units so structured are treated as autonomous segments of the business and the managers heading these segments or divisions are the functional authority in relation to all the matters pertaining to divisions. The divisional head is responsible to control and coordinate the functional units created to meet the requirements of a division. In

other words, each, division becomes a self-contained block, that each division has a separate set-off functional departments. The format of a divisional structure is as follows:



Bases of Divisionalisation: There are different bases on which various divisions in an organization can be created. The two traditional bases are product and territory. Later, many organizations have moved from these bases to strategic business units. In product divisionalisation, each major product or product line is organized as a separate unit. Each unit has its own functional structure for various activities necessary for the product. Multi-product organizations use these bases of divisionalisation. This is suitable when each product is relatively complex and large amount of capital is required for each product. The product requires different functions in terms of production, marketing, finance, etc. In territorial divisionalisation, regional offices are established as separate units. Each regional office has its own set of functional departments and operates under the strategic policies and guidelines established by a management. It is useful in those organizations where activities are geographically spread such as transport, insurance, banking, etc. In multi product or multi geographical area companies, divisions are created in the form of various strategic business units (SBUs). The fundamental concept of strategic business unit is to identify the independent product/market segments served by an organization. Since each independent product/market has a distinct environment, a strategic business unit should be created for each such segment. Thus, different strategic business units are involved in distinct strategic business areas with each area serving the distinct segment of the environment. A divisional structure has its own advantages and disadvantages.

Divisional structure offers the following advantages to an organization:

- (i) *Strict financial control:* Under this form of structure, there is strict finance control in the sense each division is a self-contained block generating a sense of competitive performance making everyone to contribute to profitability.
- (ii) *Management by exception:* It enables to apply management by exception as each division has the full freedom. There is good scope for its growth and expansion.
- (iii) *Enhancement of morale:* It also enhances employees' morale because they

enjoy full freedom to work hard which leads to their empowerment and development.

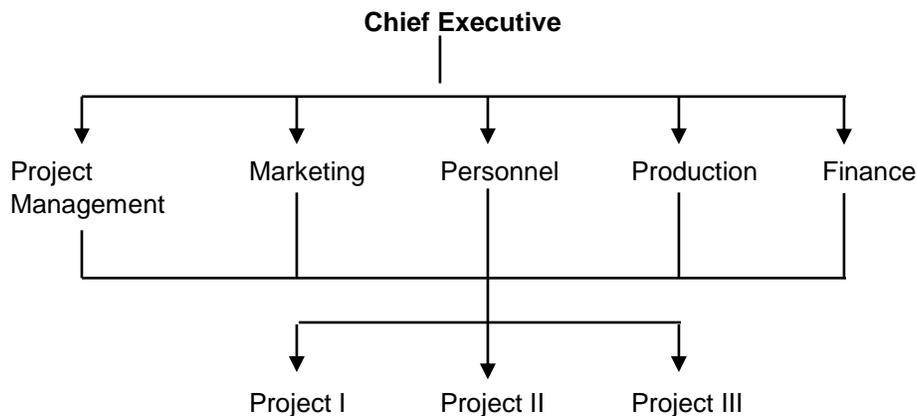
- (iv) *Care for strategic task*: It enables the senior managers' to use their energy on strategic decision making and not waste their valuable time on day to day matters or decisions.
- (v) *High efficiency level*: It brings high level of efficiency since each functional manager and his team have full liberty and they work together for each function/each division as inter-dependent department which raises the efficiency in the division and for the entire organization.

Despite various advantages, divisional structure form of organization has certain disadvantages also. Some of them are discussed as under:

- (i) *Costly affair*: It incurs extra costs since each division has its own set of functional departments and attached staff.
- (ii) *Competition between divisions*: Divisionalisation and compartmentalization leads each division to compete for more resources leading to competition among the divisions due to which one department suffers at the cost of another.
- (iii) *Coordination problem*: It becomes proposition to manage as a result of more divisions and departments
- (iv) *Change of priorities*: The service departments such as research and development in order to get higher and quick returns on investments.

(iii) Matrix Organization Structure

Matrix structure is one where each project and product becomes strategic. It is the realization of two dimensional structure which emanates from two dimensions authority i.e. pure project structure and functional structure. Authority flows vertically within functional department while authority of project manager flows horizontally crossing the vertical lines. The matrix structure configures as under:



This organizational structure is based on dual channels of authority and accountability and therefore, uses two forms of horizontal differentiations i.e. on vertical axis, the grouping of activities on the basis of functions and on horizontal axis on the basis of products and projects. Further, under this structure, people have to report to two bosses, one being the functional head of the department in which they are working and other being the leader or co-ordinator of the project on which they are working.

A matrix organization structure offers following advantages:

1. *Direct relations:* It enhances the direct relationship because matrix organization structure makes use of dual authority and accountability.
2. *Quality decision:* The quality of decisions undergoes a change for better as there is interrelation of line and functional officers.
3. *Participative management:* It encourages empowerment which results in high morale and motivation adding to quality decisions and implementation.

A matrix organization structure has following disadvantages:

1. *Conflicts and confusions:* Under this form of organization structure the principle of unity of command is violated. This leads to confusion and conflicts for the smooth working of managers. A conflict of loyalty also emerges between the line managers and project managers over the allocation of resources.
2. *Delayed decisions:* Dual reporting system results in uncertainty with regard to accountability. Further there is participative decision making which is time consuming.
3. *High degree of integration:* The coordination is the biggest problem in this type of organization structure because of duality in responsibility and accountability which is inherent in this form of corporate structure.

(iv) Free Form Organization

The free-form of organization model is based on the premise that the organization is an open system and basic task of the manager is to facilitate the change in the organization. This requires greater organizational flexibility and adaptability. Free form organization is a rapidly changing, adaptive, temporary system organized around problems to be solved by groups of relative strangers with diverse professional skills. This form of organization reduces the emphasis on positions, departments, and other formal units and on the organizational hierarchy. In this the traditional man boss relationship disappears. This form of organization is suitable for those industries which have to work in highly dynamic environments. Such environments are characterized by high flexibility and ever changing character.

From above, it is clear, that there does not exist best form of organization structure. Any organization structure is considered best which fits in organizations environment and internal characteristics which are affected by strategy.

Functional structure is generally suitable for stable environments which place less demand on inter-departmental coordination and innovation whereas divisional

structure is more appropriate for dynamic environments, which require faster response, better coordination, communication and innovation. In case of strategy is to achieve expansion through merger or acquisition, then increase in size will require a changed structure. Structure does not impose restrictions on strategy. However, if there are major strategic changes which influence environment and internal variables in the organization, then structural changes becomes unavoidable. Thus, the organizations implement, most strategies retaining the old structure and fine tune it as per requirements.

Choose your option:

The activities are grouped according to the types of products manufactured or different market territories as the organizations began to grow by expanding variety of functions performed is called:

- (a) Functional Structure***
- (b) Divisional Structure***
- (c) Matrix structure***
- (d) Free Form Organisation***
- (b) Divisional Structure***



PROCEDURAL IMPLEMENTATION

A procedure refers to a series of related task which make-up a chronological sequence. It is an established way of performing the work to be accomplished. Procedural implementation level concerned with completion of all statutory and other formalities which have been prescribed by the Government both at Central and State. The major procedural requirements involved in the strategy implementation process are discussed as under:

(i) Licensing Requirements

The licensing provisions have been provided under the Industries (Development and Regulation) Act, 1951. In many industries industrial license is required particularly in those industries which are perceived to be injurious to public health.

(ii) FEMA Requirements

Under the provisions of FEMA, all companies registered under the Companies Act, 1956 having foreign shareholding in excess of 50% and all foreign companies are required to obtain permission from Reserve Bank of India, regarding different activities like, fresh investments, issue of shares and debentures, acquisition of an Indian business unit, etc.

(iii) Foreign Collaboration Procedures

The emergence of joint venture projects with foreign collaborators brings technology and participation in equity. Besides, joint ventures, Indian companies may

enter technology agreements for the import of technical know-how. In the case of joint venture and technology agreement prior approval has to be received from the Central Government.

(iv) Capital Issue Requirements

Under the provisions of Securities Exchange and Board of India Act, 1992, SEBI exercises some controls over capital issues to the public in the form of adherence to disclosure norms. For this purpose, SEBI scrutinizes the prospectus of the company intending to enter the capital market to ensure that relevant information has been provided in the prospectus on the basis of which the public can analyze the worth of issue of shares or debentures. For raising funds from abroad by way of Global Depository Receipts, American Depository Receipts, and long term loans, prior permission of the Central Government is required.

(v) Import and Export Requirements

Import and Export requirements differ in two types of goods i.e. which are under the list of open general license and those under restrictive list. There is less requirements for items falling under open general license except that the companies going for import/exports have to inform the Reserve Bank of India. However, import and export license is required to be procured from the Ministry of Commerce in the case of items falling under restrictive list.

BEHAVIOURAL IMPLEMENTATION

Strategic choice is influenced by various subjective factors such as decision styles, attitude to risk and internal power play between the strategists. The strategy implementation process is also influenced by the behaviour and attitude of the strategist along with organizational factors such as corporate culture, corporate values, ethics and organization sense of social responsibility.

Behavioural implementation is concerned with those aspects of strategy implementation which have influence on the behaviour of the people in the organization. Since the organization is basically a deliberate creation of human beings for certain specified objectives, the activities and behavior of its members need to be directed in certain way. Some of the issues which are relevant for behavioural implementation of strategy in an organization are discussed as under:

(i) Leadership

Leaders are the vital aspect of an organization which helps to cope the change by ensuring that plans and policies formulation are implemented as planned. Leadership is basically the ability to persuade others to achieve the defined objectives willingly and enthusiastically. A strategic leadership involves the process of transforming an organization with the help of its people so as to put it in a unique position. Thus, strategic leadership transforms the organization which involves changing all faces that is size, management practices, culture and values etc. Further, it emphasizes people because they are the source for transforming various physical and financial resources of the organization into outputs that are relevant to

the society. Thus, the elements of strategic leadership may be summarized as under:

- (i) It deals with vision keeping the mission insight and with effectiveness and results.
- (ii) It emphasises on transformational aspects which leads to emergence of leaders in the organization.
- (iii) It inspires and motivates people to work together with a common vision and purpose.
- (iv) Strategic leadership has external focus rather than internal focus which helps the organization to relate it with its environment.

A leader initiates the actions for putting a strategy into operation. Strategist's leadership role in strategy implementation is as important as his role of architect of strategy. A leader should adopt the following initiative for implementing the leadership strategy:

- (a) Developing new qualities to perform effectively
- (b) Be a visionary, willing to take task and highly adaptable to change
- (c) Exemplifying the values, culture and goals of the organization
- (d) Paying attention to strategic thinking and intellectual activities
- (e) Adopting a collective view of leadership in which the leaders' role is highlighted at all levels of the organization
- (f) Empowering others and emphasising on statesmanship
- (g) Adopting a perspective to build subordinate skills and confidence to make them change agents
- (h) Delegating authority and emphasizing on innovation.

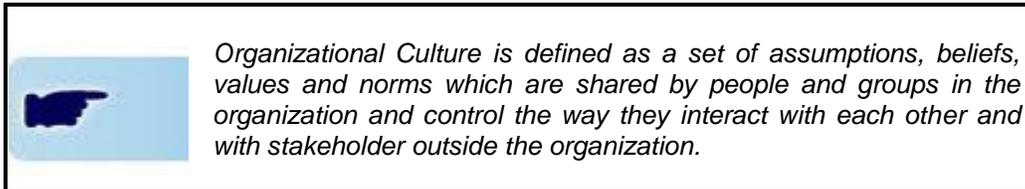
Merely understanding the role of leadership in strategy implementation is not enough. The leader should match his styles according to the requirements of the strategy. Leadership styles are the pattern of behavior which a leader adopts in influencing the behavior of his subordinates in the organizational context. There are various dimensions for describing leadership styles such as use of power in influencing the behavior, employee task orientation and emphasis on reward or punishment in influencing the behavior. Each of these dimensions have varying degrees of orientation. There are different types of leadership styles and their suitability depends on the nature of environment. Therefore, the most appropriate style of leadership should be adopted for the strategy implementation.

Thus, for an effective and successful implementation of choosen strategy in the organization, there is a need to ensure the selection of the right strategist in the right place at the right time.

(ii) Organizational Culture

Organizational culture affects strategy implementation as it provides a framework within which the behavior of the members takes place. There are two types of

elements which define the culture of an organization i.e. (i) abstract elements and (ii) material elements. Abstract elements are internally oriented and include values, attitudes, beliefs and feelings. Material elements are extremely focused and include building, personnel dresses, products etc.



Organisation culture is not the same as corporate culture. It is wider and deeper concept, something that an organization 'is' rather than 'it has'. Organization culture may be conservative, innovative or mix of two. It basically develops norms of behaviour, attitude, feelings, perception, myth etc. Charles Hardy divided the organisation culture in the following four types:

- (i) *Power Culture*: Under this type, the organization is dominated by either a very powerful individual or dominant small group. All the strategic decisions in the organization are made by the central authority or group. In such situation, power derives flows from top person and personal relationship with that individual matters more than any formal title or position. This type of culture is generally common in small entrepreneurial companies and groups.
- (ii) *Role Culture*: Under this type, the task of management is to manage procedure. Co-ordination is at the top and role descriptions and authority are defined. There is usually high degree of decentralization and organization runs as per laid down rules and procedures. This type of culture is very common in traditional bureaucracies and response of the organization is slow due to slow decision making process.
- (iii) *Task Culture*: It is very much small team approach common in firms engaged in project. Here, the emphasis is on results and getting thing done. Individuals are empowered with discretion and control over their work. This type is somewhat flexible and adaptable in nature and consists of experts. Strategic planning tends to concentrate on task in hand.
- (iv) *Person Culture*: Under this type, individual is the central point. If there is a structure, then it exists to serve only individuals within it. The culture exists for people concerned. It has no super operative objective. This type of culture is commonly seen in professional societies bodies', trade unions, religious bodies, universities, etc.

Organisation culture affects the following aspects of the organization:

- (a) *Objective setting*: The objectives of the organization must reflect at least in part, the objectives of its members particularly those who are key in decision making.
- (b) *Work ethics*: Ethics relates to conformity to the principles of human conduct. Work ethics in an organization is derived from its culture. Thus, corporate

culture determines the ethical standards for the organization as a whole and its individual members.

- (c) *Motivational pattern*: Corporate culture also determines the way people approach their jobs and even life in general. If organizational culture is geared to its achievement, people will feel quite motivated and will use their utmost energies for the work.
- (d) *Organizational process*: Various organizational processes like planning, decision making, controlling etc., are determined by the organizational culture because these processes are carried out by the people in the organization.

The organizational culture should be made as a facilitating factor in strategy implementation. The following alternatives have been suggested for implementation in relation to strategy and culture:

1. *Ignore corporate culture*: Strategists can simply ignore the corporate culture while implementing the strategy especially when it is not possible to change corporate culture. Corporate culture is built over a period of time and therefore, can not be changed overnight.
2. *Adopt a strategy to suit corporate culture*: Strategists may have flexibility in organization design, organizational system and process for strategy implementation.
3. *Change corporate culture to suit strategic requirements*: The third alternative to change the strategy itself if it does not fit with the corporate culture. However, changing strategy midway is not a desirable proposition. Therefore, the corporate culture should be considered as a determinant of a strategic choice.
4. *Change the strategy to fit the corporate culture*: This is the optimum choice in the prevailing Indian business environment. Many companies have failed because they were not able to adopt suitable strategies due to corporate culture constraints. Though cultural change process is slow, attempt be made to change the culture.

(iii) Organization Development (OD)

Organization Development (OD) is another aspect of leadership implementation which involves change processes.



Organization development refers to long-term effort supported by top management to improve an organization's problem-solving and renewal process through effective management of organizational change.

Change is a way of life in today's organization. OD efforts are planned, systematic approaches to change. They involve changes to the total organization or to relatively large segments of it. The purpose of OD efforts is to increase the effectiveness of the system and also to develop the potential of individual members.

The major characteristics of OD programs are:

- (i) A planned strategy to bring about organizational change. The change effort aims at specific objectives and is based on a diagnosis of problem areas.
- (ii) A collaborative approach to change which includes the involvement and participation of all members within an organization.
- (iii) An emphasis on ways to improve and enhance performance.
- (iv) A systems approach concerned with the interrelationship of various divisions, departments, groups and individuals as interdependent sub-systems of the total organization.
- (v) A set of humanistic values about people and organizations that aims at gaining more effective organizations by opening up new opportunities for increased use of human potential.

OD strategy is a continuing process of long-term organizational improvement consisting of a series of stages:

- (i) The awareness of a need for change.
- (ii) The entry and intervention of a consultant.
- (iii) Developing the consultant-client relationship.
- (iv) The information-collecting phase.
- (v) The diagnostic phase.
- (vi) Action plans strategies and techniques.
- (vii) Monitoring, reviewing and stabilizing action programs.
- (viii) The termination of an OD program.

Planned organizational change is a deliberate attempt to modify the functioning of the total organization or one of its major parts in order to bring about improved effectiveness.

The culture of the organization becomes a part of the people who perform the work. In changing these old patterns, people must alter not only their behavior but also their values and view of themselves. Organization structure, procedures and relationships continue to reinforce prior patterns of behaviour and to resist the new ones.

The major ingredients of a successful change process are as follows:

- (i) Top-level commitment, clearly and visibly evident to all staff.
- (ii) A shared vision of how to organize and manage for competitiveness.
- (iii) Full involvement and commitment from the employees.
- (iv) A good performance measurement system.
- (v) Continuous training and education.
- (vi) Systematic and reinforcing communication.
- (vii) Recognizing and rewarding people for change.

- (viii) Institutionalizing revitalization through formal policies, systems and structures.
- (ix) Establishing consistency with other major change projects with clear explanations of how they will fit the overarching business strategy.
- (x) Monitoring and adjusting strategies in response to problems in the revitalization process.

(iv) Values and Ethics

Values are convictions and a framework of philosophy of an individual on the basis of which he judges what is good or bad. Values represent basic convictions that a specific mode of conduct is personally or socially preferable to an opposite mode of conduct. Values may be either terminal or instrumental. Terminal values reflect what a person is ultimately striving to achieve i.e. comfortable life, family security, self respect etc. Instrumental values relate to means for achieving goals i.e. courage, honesty, imagination, etc. The values are generally enduring in nature; an individual adapts new values and refines the old ones in the light of new knowledge and experience.

Ethics are concerned with moral principles or set of values about what conduct ought to be. It specifies what is good or bad, right or wrong from social point of view. Business ethics operates as system of values and is concerned primarily with the relationship of business goals and techniques to specify human ends. Business ethics generates from: (a) value forming institutions; (b) organizational values and goals; (c) colleagues; and (d) professional code of conduct.

Values and ethics affect an organization and its members in the following ways:

- The decisions and solutions to the problems.
- The way the members see others.
- The method in which the members perceive situations and problems they face.
- The extent to which the organization and its members accept or resist external pressures.
- Perception of individual and organization success as well as achievement.

Strategy implementation is, thus, mostly affected by instrumental values of people in the organization. From strategic management point of view, people in the organization are divided into—Board of Directors, Chief Executives, managers and corporate planning staff. Of these groups, Chief Executive and managers under him are mostly responsible for strategy implementation. However, values are held by individuals which are part of their personality. Therefore, it is quite likely that values of different individuals do not match each other. Thus, in actual practice, the relationship between organizational values and personal values exists in the organisation.

(v) Corporate Governance

Corporate Governance is a system by which companies are directed and controlled based on code for good corporate practices.

“Corporate Governance deals with laws, procedures, practices and implicit rules that determine a company’s ability to take informed managerial decisions vis-à-vis its claimants — in particular, its shareholders, creditors, customers, the state and employees. There is a global consensus about the objective of ‘good’ corporate governance: maximizing long-term shareholder value”.

-According to CII Desirable Corporate Governance Code

“Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company”.

- According to N R Narayana Murthy Committee



Corporate Governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders.”

-According to ICSI

To sub serve the above ends, corporate governance must be based on following principles:

- Transparency in Board processes and independence in the functioning of Boards. Board should provide effective leadership to the company and management for achieving sustained prosperity for all stakeholders. It should provide independent judgement for achieving company’s objective.
- Accountability to stakeholders with a view to serve the stakeholders and account to them at regular intervals for actions taken, through strong communication processes.
- Social, regulatory and environmental concern.

Objective of Corporate Governance: Good governance is integral to the very existence of a company. It inspires and strengthens investor’s confidence by ensuring company’s commitment to higher growth and profits. It seeks to achieve following objectives:

- (i) A properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs;
- (ii) The Board is balanced and regarded the representation of adequate number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders;
- (iii) The Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information;
- (iv) The Board has an effective machinery to sub serve the concerns of stakeholders;

- (v) The Board keeps the shareholders informed of relevant developments impacting the company;
- (vi) The Board effectively and regularly monitors the functioning of the management team; and
- (vii) The Board remains in effective control of the affairs of the company at all times.

The overall endeavour of the Board should be to take the organization forward, to maximize long-term value and shareholders' wealth.

A good corporate governance code usually contains the following matters:

- (i) *Constitution of Board of Directors*: Constitution of Board of Directors, role of non-executive directors, its meeting, key matters to be brought before the Board etc.
- (ii) *Disclosure of Information*: Disclosure of financial and other information in the company's annual accounts and reports as well as periodical disclosures.
- (iii) *Management practices*: The practices adapted by the managers to protect the interest of shareholders, consumers, creditors, lenders, Government and the society.

(vi) Corporate Social Responsibility

Corporate social responsibility (CSR) is a tool used by business and industry to align operations with social and environmental values. CSR, is generally viewed as the voluntary commitment and action undertaken by a corporation, over and above compliance to existing legal requirements, to behave in an ethical manner to address both i.e., its own competitive interests and the wider interests of society. CSR focuses on benchmarking the success of a company's performance on social, environmental and financial indicators, known as the triple-bottom-line. CSR's overall goal is to positively impact society and the natural environment while achieving business success.



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 stays within the rules of the game, which is to say, engage in open and free competition, without deception or fraud.

(Milton Friedman's)

Corporate social responsibility is the soul of every business these days. It has also become the password to not only overcome competition but to ensure sustainable growth. It has been supported not only by the shareholders but stakeholders by and large encompassing the whole community. CSR in truth is the alignment of business operations with social values. It takes into account the interests of stakeholders in the company's business policies and actions. It focuses on the social, environmental, and financial success of a company the so-called triple bottom line with the aim to achieve social development while achieving business success. More importantly, CSR is the point of convergence of various initiatives

aimed at ensuring socio-economic development of the community which would be livelihood oriented as a whole in a credible and sustainable manner.

Corporate social responsibility demands that organizations behave as good citizens while pursuing purely commercial goals. It is of the opinion that organizations should conduct themselves on the basis of certain fundamental principles such as:

- Concern for the quality of life including life at work.
- Concern for the physical environment.
- Fair reward for effort and enterprise.
- Interest and involvement in activities of the wider community.
- No misrepresentation in advertising or fraudulent activities.
- No unfair discrimination in hiring, promotion or dismissal of employees.
- Compliance with laws and established customs of the community.

(vii) Organizational Politics

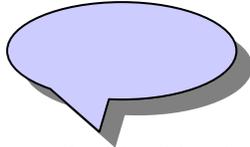
Politics can be referred to as actions for seizing, holding, extracting and executing of power by individuals and groups for achieving personal goals. The organization decisions are affected because of organizational politics in such a way that they constitute to personal goals rather than organizational goals. Practically, no organization is free from politics; strategists may have two approaches for utilizing politics and power structure in a beneficial way to the organization.

The first approach regard to understanding and managing politics and second approach is regard to elimination dysfunctional consequences of politics. In the first case strategists undertake strategy implementation through consensus building, managing coalition and creating commitments. Based on the understanding of power structure, the strategists gather support for acceptable proposals and ignore the non-acceptable ideas.

The second case revolves in taking various measures so that the organizational politics do not have any serious dysfunctional consequences. In this regard the following actions are suggested:

1. Ensuring clarity in job definitions, roles, rules, procedures and authority. Clarity in these aspects helps in minimizing favoritism, nepotism, unfairness and opportunity for people to advance themselves at the expense of others.
2. Top management should not indulge in dysfunctional politics and should also discourage it by implementing a strategy that such a behaviour is to be penalized.
3. Management may take direct action to curb political behaviour.
4. There should be objective criteria for setting objective for individuals and the rewarding of individuals should be solely on attainment of these objectives. When objectives are clearly specified any deviation from it will be clear and it will be easier to control. By penalizing negative behaviour and rewarding positive behaviour members can be motivated to engage in positive manner.

Behavioural Implementation



- *Leadership: It is the ability to persuade others to achieve the defined objectives willingly and enthusiastically*
- *Organizational culture: It is a set of assumptions, beliefs, values and norms which are shared by people and groups in the organization and control the way they interact with each other and with stakeholder outside the organization.*
- *Organizational Development: It refers to long-term effort supported by top management to improve an organization's problem-solving and renewal process through effective management of organizational change.*
- *Values and Ethics: Values represent basic convictions that a specific mode of conduct is personally or socially preferable to an opposite mode of conduct. Ethics is concerned with moral principles or set of values about what conduct ought to be.*
- *Corporate Governance: It is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders.*
- *Corporate Social Responsibility: It is a tool used by business and industry to align operations with social and environmental values.*
- *Organizational Politics: Politics can be referred to as actions for seizing, holding, extracting and executing of power by individuals and groups for achieving personal goals. The organization decisions are affected because of organizational politics in such a way that they constitute to personal goals rather than organizational goals.*

FUNCTIONAL IMPLEMENTATION

The implementation of strategy also requires development of functional policies which provide the direction to middle management on how to make the optimal use of allocated resources. They guide the middle level executives in framing operational plans and tactics to make strategy implementable. Policies are basically general guidelines to help executives to make certain choices. They are developed in order to ensure that strategic decisions are implemented.

In order to formulate plans at the functional level, the strategist has only to decide which functional area goals (or set of related goals) for which it is necessary to formulate action plans. A single goal may require action plans at several functional areas such as marketing, finance, research and development, personnel, production and external relations are explained below:

MARKETING STRATEGY

Marketing policy provides the guidelines for managerial decision making and actions to carry out the marketing functions in line with chosen strategy. It basically focuses on the organizations' existing and potential customers and seeks to earn profit through customers' satisfaction with an integrated programme. Broadly speaking, marketing policy and plan addresses the issues such as pricing, distribution, promotion and product lines with a view to counter competition from rival.

Pricing: Organization strategy regarding product/services prices is to accomplish the four fundamental things i.e. (i) change in profitability; (ii) change in sales level or growth rate; (iii) change in net cash flow; or (iv) maintenance of present sales, profit, or cash flow level. Marketing goals and action plans deal with price by specifying the planned-for impact on company performance desired strategy.

The task of actually setting price to yield the impact is normally the responsibility of the firm's marketing director where marketing is decentralized.

The major factors which are taken into account while formulating the pricing policy include the following:

- (a) Prices of competing product;
- (b) Prices of different items in product line;
- (c) Cost of production and distribution;
- (d) Discriminating pricing policies for different customers;
- (e) Scope of change in prices.

The major price options which can be adopted by an organization are as under:

- Penetrating prices—means low price combined with aggressive advertising in order to capture large share in the market.
- Skimming – high price policy suitable for established top quality products.
- PLC pricing—charging initially higher prices to cover development and advertising cost. This price is systematically reduced in later stages of product life cycles.
- Incentives—such as discount, mode of payment, credit terms etc.

Distribution (Place): Channel of distribution is another important aspect of marketing policy to a strategist. Yet the corporate strategist's input to distribution system design is critical in that it sets the limits for subsequent distribution decisions. The primary element of distribution goals and action plans is a definition of planned-for coverage or exposure of products addressed at higher levels of strategy. Intended product exposure is a function of: (i) the extent to which the organization is integrated forward or backward, (ii) whether the output of intermediate steps in the production process will be marketed or retained only as components, and (iii) desired coverage, usually in geographical terms, of the items marketed. The important issues of distribution include:

- Efficiency and effectiveness of distribution channel.

- Type of channels to be used—direct to consumers, producer to retailers and producer to wholesaler.
- Intensity of distribution—number of sales outlets to be opened.
- Choice of distributors and extent of control.

Promotion: The strategist's primary concern with promotion, or, more generally, communication, is to provide guidance to the firm's marketing specialists so that marketing communication assumes a form consistent with overall strategy.

There are four types of communication methods:

1. Personal sales presentations—direct communication between sellers and potential buyers.
2. Sales promotion—displays, exhibitions, demonstrations, and trade shows to complement other communication techniques.
3. Mass advertising—communication with large aggregates of potential buyers simultaneously.
4. Public relations—free non-personal communication.

In a decentralized firm, the job of selecting a particular combination of communication methods is usually the responsibility of marketing specialists. The strategist sets communication strategy as a guide to the specialist's decisions to optimize congruence between communication methods and overall strategy.

New Product Development: As products reach the decline stage of their life cycles, they must be replaced by new products in order for the firm to grow and prosper. Thus, an integral part of a business strategy that stresses product development is a marketing strategy which defines the way in which new product ideas will be generated.

The product development process can be summarized in the following stages:

- (i) Formulation of product goals;
- (ii) Search, discovery and evaluation of new product proposals;
- (iii) Product development and testing;
- (iv) Market entry.

FINANCE POLICIES

Finance strategy is generally concerned with the acquisition and allocation of financial resources for the purpose of achieving goals at an acceptable level of risk. Thus, the setting of goals and action plans for finance can be viewed as a problem relating to the sources and uses of capital that is constrained, at least in part, by stockholders' wealth goals. Financial goals and action plans are treated from capital acquisition and allocation perspectives, though this distinction is only for expository purposes. Rarely is capital acquisition decisions made in isolation from those relating to how funds would be allocated, and vice versa.

On the matter of risk, we will find that it enters into both sources and uses problems. It is manifest primarily through the notions of financial leverage, operating leverage, liquidity, and working capital management. Higher-level strategies normally involve certain current and fixed asset investments that represent short and long-term applications or uses of funds. Specifications describing these investments are outlined in terms of capital budgeting techniques, cost-benefit analysis, and a cash budget, which serve: (i) to determine the financial characteristics of strategic investments; and (ii) as evaluative criteria for monitoring the operation of the firm under the business-level strategy. Of course, to determine the financial impact of strategic investments, a comprehensive financial analysis of the firm is necessary to define its pre-implementation financial structure. All subsequent changes can then be evaluated according to their expected effect on this financial profile.

Business-level strategy will necessitate selection from among various expenditure choices. Finance goals and action plans are needed to establish the expected outcomes and methods to be followed in such evaluations. Related decisions involve the relative amounts of capital diverted to dividends versus reinvestment in the firm.

WORKING CAPITAL MANAGEMENT

Working capital management is an integral part of a firm's day-to-day affairs and is guided to some extent directly by strategic choices. Since it entails the management of current assets and current liabilities, it involves both the allocation and acquisition of funds and/or their material counterparts. The focus of working capital is generally short term, although it interacts with longer-term decision-making in the context of strategy implementation, and insofar as short-term financing is used in lieu of long-term financing.

Allocation of after-tax net profits is the area of dividend and retention policy. Profits can either be retained in the business and ploughed back for expansion or growth. Alternatively, profits may be distributed among shareholders in the form of dividends. While formulating financial policy regarding the distribution of earnings, management should consider the company's cash position, need for additional capital, attitudes of shareholders, effect of income tax, legal restrictions etc. Dividend policy influences not only the income of shareholders but marketability of shares, credit standing of the company and its ability to raise debt.

Evaluation of financial performance and protection of assets is an important element of financial policy. Suitable standards and procedures of financial control are required to maintain and improve the financial health of an enterprise.

Thus in brief the major areas covered by financial policies include the following:

- Capital structure mix i.e. proportion of short-term debt, long-term debt preferred and common equity.
- Efficiency and effectiveness of resource utilization in terms of capital investments, fixed asset acquisition, current assets, loans and advances, dividend policy etc.
- Maximizing market valuation of the firm.

- Extent to which internally generated profits are reinvested within the firm.
- Guidelines on decisions regarding leasing versus buying of fixed assets.
- Relationship with credit agencies such as banks and financial institutions.

Financial policies are formulated within the framework of corporate strategy. For example when evaluating proposals for investments in projects, managers will select high risk projects if expansion is the desired strategy. If retrenchment strategy is being preferred then low risk projects will be selected.

The successful implementation of financial policies will enable a firm to:

- Replace capital assets when necessary.
- Pay loan and debenture interest when it falls due and repay the capital on maturity.
- Accumulate adequate reserves to meet contingencies.
- Facilitate steady long-term growth.
- Ensure ready availability of funds at the lowest cost.

The common thread in the management of working capital is cash or more generally, cash flow, which leads to changes in cash balances. In some cases, short-term cash flow is a function of long-term commitments (a capital purchase, for example) that may require a series of short-term obligations (e.g., current portion of long-term debt) or a large, non serial cash outlay. In either circumstances working capital is affected through its cash component.

The minimum cash balance carried by a firm is that which is necessary to conduct business in a manner consistent with the firm's strategies. This includes the ability to react to emergencies to maintain compensating balances, and to take advantage of profit-generating opportunities, as well as to meet regular requirements for raw material or inventory purchases, operating expenses, debt service, and other day-to-day expenditures. The management of cash balances and their near-equivalents (e.g., marketable securities) can become a critical component of strategy implementation. Certainly this would be the case for marginal firms embarking on survival or turn-around strategies involving divestment, retrenchment, or financial reorganization.

All this is not meant to imply that working capital management translates solely into the management of cash. The mix and magnitude of current liabilities and the non-cash components of current assets also have direct implications for higher-level strategy and its implementation. Though normally aimed at achieving a desired liquidity position (with a keen focus on cash flow), working capital decisions must be carefully cast in the strategic framework that guides them.

HUMAN RESOURCE MANAGEMENT (HRM) AND UNION RELATIONS POLICY

HRM has assumed a vital place in an organization. The personnel function effectively contributes in integrating strategies in various functional areas for accomplishing set objectives.

Personnel goals and action plans are set to guide the personnel department in major staffing decisions pertinent to business-level strategy. It has the following elements: (i) job analysis; (ii) staffing plan; (iii) payroll budget; and (iv) union relations strategy.

(i) *Job Analysis*: Sometimes a strategy has very specific implications for jobs. A job analysis is performed to gather pertinent information to communicate expectations about job content. The job-related data are then reported in a set of job descriptions; people-related information is arranged in a set of job specifications.

The primary role of job descriptions and specifications is to guide the process of hiring and placing people. When no new jobs are involved in a new strategy, job analysis can be conducted on existing jobs. Ideally job analysis data would already be available in the latter case; the strategist could simply refer to existing job descriptions and specifications and note the number of job titles required. Of course, the problem the strategist faces when a strategy necessitates creation of new jobs is having to decide what the content of jobs and employment requirements will be before hiring applicants.

(ii) *Staffing Plan*: The staffing plan presents the required number of employees by job title which will be needed over the strategy's planning horizon. This is a key consideration for the organizations' personnel specialists. It tells them how many and when people will have to be brought into the organizations to operationalize the strategy. Human resource planning procedures are followed to develop the staffing plan. Total employee requirements are determined by job title for the initial stages of strategy implementation. Subsequently, these totals are modified to reflect the number of current employees who can be transferred into the new jobs as well as expected normal outflows caused by retirements, deaths, out-transfers, and separations. The result is net incremental human resource demand by job title generated by the strategic change.

(iii) *Payroll Budget*: The cost of labor is a major strategy variable. It can be a primary consideration in determining the feasibility of a new strategy. The staffing budget is simply the sum of estimated total labor costs involved in the new strategy. It should be broken down by department. As such, it represents the rupee limits that functional managers cannot exceed in hiring people to implement the new strategy. Personnel strategy can address union/management relations whether or not the firm is organized by a union. By reducing the critical areas of labor/management relations to strategy, the relationship between unions and management can be productive and comfortable in unionized firms. For non-unionized firms the relationship between labor and management can be prevented from degenerating into a strictly adversarial one.

(iv) *Union Relations Strategy*: The purpose of union relations strategy is to set goals and action plans which will lead to acceptance of the new strategy set by unions representing employees of the organization.

Setting union relations strategy involves:

(a) *Relationships between Strategy and the Union Contract*: There are many possible ways in which a new strategy set can affect a union/management contract. A retrenchment strategy might involve layoffs, of which the

circumstances either could be spelled out in the contract or would have to be negotiated before implementation. Similarly, a product development strategy could necessitate a work-force expansion. The process of increasing the number of jobs and employees could be subject to contract provisions or negotiations.

Labor legislations of major countries define the range of topics subject to collective bargaining in the private sector, as matters of wages, hours, and working conditions. In the public sector, the items subject to bargaining are usually covered by statute. They differ from organization to organization.

When agreement cannot be reached as to whether an item is subject to negotiation, the appropriate authority can be called upon to make the determination. Bargaining issues for determination may be placed in three categories: mandatory, permissive, and illegal. Illegal bargaining subjects are those which are prohibited. Closed-shop agreements are in this category. Permissive items include management rights issues over which management has exclusive decision authority. Examples are product choices, pricing decisions, and types of advertisements. Permissive topics do not have to be negotiated, but can be if management so desires.

Mandatory bargaining subjects include matters pertaining to wages, hours, and working conditions, and these issues must be resolved by negotiations. Whenever a new strategy requires changing any of these three factors, it may be necessary to negotiate the company's position with affected unions.

(b) Formal or Informal Negotiations: Some items might be better left to formal negotiations whereas others could be resolved by informal bargaining. Formal negotiations are those that lead to a new contract between labor and management. Informal negotiations refer to the day-to-day discussions by the two parties about how the contract applies to particular situations. Many of the issues that surface when new strategy is developed can be resolved by informal negotiations during meetings between union and management representatives.

Items that would have to be handled through formal negotiations probably would hold up implementation of the strategy until the next collective bargaining sessions. Therefore, in practice it would be most helpful if negotiable items could be resolved informally.

(c) Preparation of Negotiation Proposals: Preparing proposals for either formal or informal collective bargaining purposes is largely a matter of conducting the necessary research to support one's position and then presenting findings, in as convincing a form as possible, during the negotiations themselves. For strategy-setting purposes, this means that proposals must be "airtight" when presented. The best strategy ever conceived can be nullified by the inability of management to gain the support of unions or failure to consider before negotiations what the implications of the strategy are for union leadership and members.

Entering Negotiations: The final phase of implementing union relations strategy is the process of entering into negotiations. This phase is usually subject to convention within the organization involved. That is, in any firm negotiations proceed according to procedures understood by both parties or spelled out by law or agreement.

PRODUCTION STRATEGY

Production is basically concerned with the process of transformation of various inputs into output in the light of objectives of the organization. The production process should be cost effective and without quality problems. To guide managers in the operation of production function in a way consistent with other levels, production strategies/policies are mainly concerned with the following aspects:

- Existing production capacity of the organization.
- Augmentation of production capacity in the short-run/long-run.
- Decision regarding plant location, plant layout and degree of automation.
- Manufacturing processes vertical integration.
- Inventory control including re-order level.
- Maintenance/replacement of existing production facilities.
- Production and purchasing policies.
- Technology planning including technology life cycle, division of labour, choice of technology.
- Modernization.
- Sourcing of inputs including reliability of suppliers.
- Quality Control and Total quality management.
- Coordination of activities.
- Organizational capabilities.
- Government policies.
- Research and Development.

An organization should frame its productional and operational policies in the light of its overall corporate strategies. In a situation when an expansion strategy is desired through internal means, the organisation should have the adequate capacity to support such expansion. On the other hand, if retrenchment policy is being considered, in that situation production volume will need to reduce to avoid stock of inventory. Thus the production and operational policies in the organization must not only be properly coordinated but they should also match with the marketing policies in order to ensure that strategy is correctly implemented.

RESEARCH AND DEVELOPMENT STRATEGY

Research and Development refers to acquisition of new technical knowledge in areas of developing new products, new processes, materials and working methods. In an organization industrial research can have one of two fundamental orientations. Scientific research refers to free-roving and analytical inquiry into the domain of unpredictable phenomena. This type of research activity is concerned with generating new concepts that may or may not have product applications.

The second orientation research on the other hand is commercial development—the ultimate business outcome of successful industrial research, with its practical aura of economic and company values and restraints. Development activity can take

several forms, but is essentially product, as opposed to concept oriented. Thus, it is a more pragmatic and market-centered form of research and development effort than scientific research.



Research and development strategy has four primary components:

- *research and development goals,*
- *extent of intensity of the research and development function,*
- *amount of market coupling desired, and*
- *size of the budget.*

(i) Research and Development Goals

Goals are needed to specify the purpose of research and development. It is used as part of product or market development or market-penetration business-level strategies. Organization's desired competitive position can largely determine the amount and type of research and development needed. More specifically, research and development can have one of four basic purposes that normally would be stated at the business level.

First, industry leader positioning can require both scientific research and commercial development capabilities but research emphasis is important for consistent generation of new concepts with development potential. The industry leader has to maintain its product pre-eminence by outstripping its competitors' new concept initiation rates. Thus, the leader tends to have a high research and development expenditure-to-sales ratio and state-of-the-art research facilities. In addition, its development capabilities must be effective and rapid. Effectiveness is largely a matter of production expertise, quality consistency, and marketing know-how. In brief, an industry leader, as one would expect, has to be good at everything and have the confidence to invest heavily in risky scientific research.

Another research and development position is that of follower. A follower is described as a firm that essentially duplicates the product innovations of the industry leader. Such firms usually strive to under price the leader by avoiding the overhead burden of a basic research function. In return, the follower has to sacrifice time, wide profit margins, and prestige by always having to wait for the leader to make a move. The more quickly a follower can respond to the leader's new introductions, the more it can capitalize on the early adopter market. Thus the follower's primary research and development capability has to be in competitive intelligence, market sensing, and development.

The third research and development position is that of adapter. The adapter scans its competitors' offerings, not just those of the leader, and then modifies selected ones to meet the needs of its market segments. It actually is not duplicating competitors' products in a strict sense, but rather is adapting them to the specific requirements imposed by its customers. The adapter is not necessarily producing a lower-quality rendition.

Adapters need strong developmental research capabilities and a keen understanding of market needs and sensitivities. Adapters modify products by means

of strategic choice, not simply as part of a product development tactic. That is, they are adapters by choice, not incidentally. Consequently an adapter searches for products to modify for its customers.

The final position with research and development implications is that of copier. Copying in this sense usually involves price competition with a leader, follower, or even adapter, which is made possible by production efficiencies, often resulting in reductions in quality. Copies of some of the more popular high-priced, high-quality units appeared at prices far below those of the originals. They also tended to have shorter warranty terms and were rougher in appearance. Their smaller profit margins and lower prices require higher sales volume, and thus more widespread distribution. Also, copiers need accurate market information and process engineering capabilities sufficient to quickly produce a high volume of less costly copies.

(ii) Intensity of Research and Development

Realistically there are seven choices of levels of research and development involvement. Larger firms will tend to have more of the different levels of research and development activity as compared to the smaller ones. The choices are as follows:

- Level 1. Basic research in seeking new conceptual developments at the frontier of a discipline with little concern for product applications. It is a risky and expensive type of research effort which is conducted by universities or other research institutions.
- Level 2. Applied research usually involves problem-initiated research and are focused on solving a problem whose nature has possible implications for the firm's product lines or items.
- Level 3. Advance development focuses on determining preliminary performance specifications for a new conceptual design which may have been produced by applied research. Output of this activity would be a detailed set of guidelines on how the new product should operate with tolerances and the necessary component configuration.
- Level 4. Design engineering converts performance specifications into design specifications, which are used to make a prototype. With appropriate refinements these specifications are the plans used for manufacturing.
- Level 5. Feasibility testing is analysis of financial or physical reasonableness of a product, process, or project.
- Level 6. Equipment engineering results in the design and development of machinery and equipment peculiar to the manufacturing needs of a product or component.
- Level 7. Process engineering is the design of production operations necessary to manufacture an item or to convert design specifications.

When creative research and development is required for a strategy, the tendency

will be to implement a research and development program which consists of advance development or applied research. Conversely, a strategy calling for merely copying another product would not require these high-level research functions. The organisation could operate successfully with process, or possibly design, engineering functions alone. In terms of their relationships to the finished product, basic research is the most distant, and process engineering is the closest. Selection of the level of integration of research and development identifies the type of research and development effort appropriate for a business-level strategy.

(iii) Market and Production Coupling

Market and production coupling is the practice of controlling the output of a research and development operation by the input of marketing and production information. For example, an applied research group could be "managed" by systematically informing researchers of pertinent marketing data such as customers' preferences and competitors' product attributes, or production quality maintenance problems and cost structures. This should result in their work having market relevance and reflecting production realities. The information normally would be transmitted at regular meetings between appropriate managers and key research and development staff people.

Further, there is always danger that researchers will pursue their own interests with limited market or production applicability at research and development intensity stage. This could result in too few new product ideas even though the researchers' professional development would be considerably enhanced. Organizations investing large amounts of resources in basic research programs can destroy their creative effectiveness, though, by too much market coupling. Thus, the extent of coupling is a critical determination for the strategist in designing and managing a research and development program at all levels, not just in basic research.

The choices facing the strategist concerning coupling are straightforward. For each level of research and development activity, research and development strategy should specify: (i) the presence or absence of a market and/or production information input system; and (ii) the type of data that should be so transmitted. Responsibility for designing and implementing this information system would normally be held by a functional manager.

(iv) Research and Development Budget

Research and development goals and strategy should also specify the size of the research and development budget. A research and development budget, which can be viewed as a limit for research and development expenditures, is often expressed as a percentage of sales. However, this basis for research and development expenditures can lead to financial difficulties because it ignores consideration of whether there is sufficient profitability to cover research and development costs. Alternatively, the research and development budget could be a function of a profit measure. A research and development budget can also be set according to industry practices. But the average research and development expenditure of competitors is a minimum below which management could find itself at a competitive disadvantage.

STRATEGIC PROGRAMMING

A programme is a statement of the activities or steps needed to accomplish a single use plan. Program can be defined as a list of planning activities or the plan for future action. The programs make the strategy action oriented. In implementation any strategy is broken down into smaller programs. It may involve restructuring the organization, changing the company's internal culture or beginning a new research effort.

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Illustration:

A company which wants to follow a growth strategy may use different programs such as to compete in every market or to concentrate in some selected markets where the competitor's position is weak or to find new market or new usages of it's products etc.

Thus, programs are a set of planned activities to implement desired strategy.

Strategic programming concerns with planning as to how the deliberate strategy can best match the intended strategy to the realized strategy for effective implementation of strategy. Hence, the planning is focused on implementation of intended strategy. A strategic programming is aimed at producing a particular kind of realized strategy.

The major elements of strategic programming are as follows:

- (i) Identification mission.
- (ii) Setting Objectives.
- (iii) Developing alternative strategies.
- (iv) Evaluation of strategies.
- (v) Selection of optimal alternatives
- (vi) Preparation of master plans.
- (vii) Preparation of medium term plan.
- (viii) Preparation of short-term plan.
- (ix) Evaluation of results.

Limitations of Strategic Program

The major limitations of strategic programme to an organization originates from its limited application to certain conditions which are summarized as under:

1. *Required Conditions:* The fulfillment of required conditions by an organization is one of the important limitation of strategic programming. Strategic planning is most appropriate to those organizations which are confronted with stable, simple and normal conditions. Further once the

organization crosses this limit the following conditions are also fulfilled:

- Stability
 - Simplicity
 - Industry maturity
 - Capital intensity and
 - External control.
2. *Falling visibility of Mechanistic Organizations:* Mechanic structure is founded on formal hierarchy taking a changed pyramid to design making it rigid, complex and highly centralized. Lack of freedom and inadequate communication are hindrances to achieve efficiency and discipline. Strategic programming goes well with mechanistic organization. This itself is a limitation that it can not work in other types of organization.
 3. *Planning Problems:* Strategic programming is impossible without planning. In some cases planning leads the organizations away from the main track of progress or normalcy because managers are not aware as to where their intended strategy will take them. Further, planning is inherently a conservative process so much so that the managers find that it is ill-suited to change course i.e., planning works to conserve the basic orientation of an organization.
 4. *Difficulties with command and control:* There are difficulties in enforcing command and control: Managers in organization develop commands which reflect that their understanding of the plans are derived from the intended strategy. They use the organizational control system to enforce it in order to comply with those commands. The command and control lose its effectiveness because:
 - (i) the managers at the top level may have formal authority to issue commands but they lack the expertise to do it cleverly.
 - (ii) the traditional command and control system believe in retaining the trained employees as huge resources are invested in their training and development. However, as a competitive edge, down sizing is quite natural where command and control losses its effectiveness.
 - (iii) as the personnel is trimmed, the people at higher level who were commanding and controlling are dispensed with.

BUDGETS

Budget is a statement of a company's programmes in financial terms. A budget lists the detailed cost of each programme. Many companies demand a certain percentage of returns on investment, before management will approve a new programme. This ensures that the new programme will significantly add to the company's profit programme and thus build shareholders value. The budget thus not only serves a detailed plan of the new strategy in action, as also specifies through proforma financial statements the expected impact on the company's financial structure. Planning a budget is the last real check a company has on the feasibility of its selected strategy. An ideal strategy might be found to be practical only after specific implementation programs are costed in detail.

Budgets are effective tools both for implementation and control phases in strategic management. Budgets have three purposes: they help to refine organisational objectives, allocate resources in the most effective manner and promote efficient and optimal use of resources. They force the managers to account for use of material and capital resources. The managers are expected to gather information about actual costs incurred for the specified period and then compare these costs to budgeted costs. If there are deviations in actual costs from budgeted costs, then these can be corrected and certain control strategies can be implemented so that deviations can be avoided in future.

Budgets are widely used as control measure because they establish clear performance standards and any deviations can be quickly detected and corrected. Also, since the budgets are expressed in monetary terms, they can be more comprehensive, convenient and flexible control devices covering most organizational activities such as production, marketing, hiring, and training of personnel and so on. Budgeting compels managers to think ahead by formalizing their responsibilities for planning and provides definite expectations which can be used for judging subsequent performance. Further, it aids managers in coordinating their efforts, so that the objectives of the organization as a whole match the objectives of its parts.



A budget is a tool used for both planning and control. At the beginning of the period, the budget is a plan or standard; at the end of the period, it serves as a control device to help management measure its performance against the plan so that future performance may be improved.

Master Budget

A master budget summarizes the planned activities of all sub-units of an organization i.e., sales, production, distribution, finance etc. It is a plan of activities expressed in monetary terms of the assets, equities, revenues, and costs which will be involved in carrying out the plans. In other words, a master budget is a set of projected or planned financial statements or a consolidated summary of the various functional budgets. The master budget is a summary of company's plans that sets specific targets for sales, production, distribution and financing activities.

Components of Master Budget are the following:

Operating Budget: An operating budget is the annual budget of an activity stated in terms of budget classification code, functional/sub-functional categories and cost accounts. It contains the estimates of the total value of resources required for the performance of the operation including reimbursable work or services for others. It also includes estimates of workload in terms of total work units identified by cost accounts.

Sales Budget: It is the budget which contains the operating plan for a period expressed in terms of sales volume and selling prices for each class of product or service. Preparation of a sales budget is the starting point in budgeting exercise since the sales volume influences nearly all other items. Thus, it is estimated amount of anticipated sales allocated by product, territory, or person; prepared weekly, monthly, or annually in an organization.

Purchase Budget: Purchase budget covers the operating plan for a period expressed in terms of purchase volume and purchase prices for each class of product or service. Preparation of a purchase budget is an important component of the master budget of merchandising or manufacturing firms. It projects the quantity of goods to be purchased for the designated budget period and thus follows the basic format of the cost of goods sold section of the income statement.

Operating Expenses Budget: This budget embraces the impact of operating decisions. It contains forecasts of cost of goods sold, direct material, direct labour, factory overhead, selling and administrative overheads and other expenses etc.

Financial Budget: The financial budget is a major component of a master budget. It embraces the impacts of the financial decisions of the firm. It is a plan including a budgeted balance sheet (schedule for expected assets, liabilities, and capital). It projects a company's financial position at the end of the budgeting year.

A financial budget:

- (i) discloses unfavorable financial condition that management may want to avoid;
- (ii) serves as a final check on the mathematical accuracy of all other budgets; and
- (iii) highlights future resources and obligations, which shows the effects of planned operations and capital investments on assets, liabilities, and equities.

A financial budget includes a cash budget which forecasts the flow of cash and other funds in the business. Cash budgeting is a critical part of budgeting because it is essential to have the right sums of cash available at the right time.

Zero-Based Budgeting (ZBB)

Zero-based budgeting is a technique of planning and decision-making. It may be defined as a planning and budgeting process which requires each manager to justify his entire budget request in details from scratch and shift the burden of proof to each manager to justify why he should spend any money at all. This approach requires that all activities be analyzed in decision packages which are evaluated by systematic analysis and ranked in order of preference.

Zero based budget is different from traditional budgeting where departmental manager justify only increases over the previous year budget and what has already been spent in sanctioning.

Some of the main advantages of this approach includes the following:

- (i) Efficient allocation of resources, as it is based on needs and benefits.
- (ii) Drives managers to find out cost effective ways to improve operations.
- (iii) Detects inflated budgets.
- (iv) Useful for service departments where the output is difficult to identify.
- (v) Increases staff motivation by providing greater initiative and responsibility in

decision-making.

- (vi) Increases communication and coordination within the organization.
- (vii) Identifies and eliminates wastage and obsolete operations.
- (viii) Identifies opportunities for outsourcing.
- (ix) Forces cost centers to identify their mission and their relationship to overall goals.

This approach suffers from certain disadvantages which are discussed as under:

- (i) Difficult to define decision units and decision packages, as it is very time-consuming and exhaustive.
- (ii) Forced to justify every detail related to expenditure.
- (iii) Necessary to train managers.
- (iv) Honesty of the managers must be reliable and uniform.

Incremental Budgeting

Incremental budgeting is a budget prepared using a previous period's budget or actual performance as a base, with incremental amounts added for the new budget period. Under this approach, the allocation of resources is based upon allocations from the previous period. It encourages spending up to the budget to ensure a reasonable allocation in the next period.

<i>The major advantages of budget includes the following:</i>	<i>The major disadvantages of budget includes the following:</i>
<p>The budget is stable and change is gradual.</p> <p>Managers can operate their departments on a consistent basis.</p> <p>The system is relatively simple to operate and easy to understand.</p> <p>Conflicts are avoided when departments appear to be treated similarly.</p> <p>Co-ordination between budgets is easier to achieve.</p> <p>The impact of change can be seen quickly.</p>	<p>It assumes activities and methods of working will continue in the same way.</p> <p>There is no incentive for developing new ideas.</p> <p>There is no incentive to reduce costs.</p> <p>It encourages spending up to the budget so that the budget is maintained next year.</p> <p>The budget may become out-of-date and no longer relate to the level of activity or type of work being carried out. The priority for resources may have changed since the budgets were originally set.</p> <p>There may be budgetary slack built into the budget, which is never reviewed. Managers might have overestimated their requirements in the past in order to obtain a budget which is easier to work within, and which will allow them to achieve favourable results.</p>

Budget as an Early Warning System

Budgets provide a kind of early warning system that, when compared to actual results, can inform when something is going wrong which needs immediate attention. When expenditures exceed budget, several things can be done to get back on track as:

- *Review the budget:* Take a close look at the budget and make sure that the assumptions on which it is based are accurate and make sense in changing market. If the market is growing quickly, adjust the estimates then adjustment of estimates is required.
- *Freeze spending:* One of the quickest and most effective ways to bring spending back in line with a budget is to freeze expenses such as pay raises, new staff, and bonuses.
- *Postpone new projects:* New projects, including new product development, acquisition of new facilities, and research and development, can take up a lot of money. A suitable evaluation may fix the priority.
- *Lay off employees and close facilities:* This is the last resort to cut expenses. Although these actions will result in an immediate and lasting decrease in expenses, it faces an immediate and lasting decrease in the talent available to the organization. Productivity and morale of remaining employees may also suffer.

PROCEDURES

After the program, divisional and corporate budgets are approved, procedures must be developed. These are often called standard operating procedures. Procedures are sequential steps or techniques that describe how a particular task or job is to be done. They typically detail various activities that must be carried out to complete a program. Once in place they must be updated to reflect any change in technology as well as strategy. These procedures ensure that the day-to-day operations will be consistent over time and over locations.



Procedures prescribe the chronological sequence of performing various tasks which are required to complete an activity. A procedure includes how each task in an organization will take place, when it will take place and by whom it is to be performed.

Normally procedures are established for all the activities which are recurring in nature such as procurement of material, execution of orders etc. Since procedures are used very frequently it should be developed in such a way as to contribute positively in performing various activities. The following guidelines may be adopted for developing good procedures:

- (i) *Based on facts:* A procedure should be based on facts of the particular situation and not on guess work. For each case due consideration must be given to the objectives, the physical facilities, the personnel and the type of work. The procedure should be such that it does not hinder the efficiency.
- (ii) *Stability:* A procedure should possess stability as it provides a steadfastness of the established course with changes made only when fundamental

modifications in the factors affecting the operation of the procedure. Stable procedure provides continuity in the action and people get well-versed with the system.

- (iii) *Flexibility*: Flexibility of procedure is desirable in order to cope with a crisis or emergency or adjustment to a temporary situation. A balance should be maintained between stability and flexibility of the procedure.
- (iv) *Updated Procedures*: There should be a continuous review of procedures so that their utility is ascertained. The periodical review specifies the type of changes that are required in the procedures to make them more viable; new procedures to be added and redundant to be eliminated.
- (v) *Minimum Procedures*: Procedures should be kept to the minimum possible level as every procedure costs to the organization in terms of manager's time, paper handling, delay and lack of responsiveness to change.
- (vi) *Procedures as a System*: Procedures must be recognized as a system of interrelated activities of a network. The designing of a procedure should be linked with organizational relationship and all factors should be taken into account which affect these relationship.

STRATEGIC CONTROL

Strategic control is concerned with that aspect of strategic management through which an organization ensures whether it is achieving its objectives contemplated in the strategic action. Strategic control involves the monitoring and evaluation of plans, activities, and results with a view towards future action, providing a warning signal through diagnosis of data, and triggering appropriate intervention, be they tactical adjustments or strategic re-orientation. Strategic management is basically divided into two distinct part i.e. strategic evaluation and strategic control. However, because of the nature of strategic evaluation and strategic control both these are intertwined. Therefore, the term strategic control includes evaluative aspect also.



Strategic control is “the critical evaluation of plans, activities, and results, thereby providing information for the future action”. Strategic control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.” There are four types of strategic control: premise control, implementation control, strategic surveillance and special alert control.

Application of Strategic Control

Strategic control processes should ensure that strategic aims are translated into action plans designed to achieve these aims, and that the effectiveness of these plans are monitored. An effective strategic control process should ensure that an organization is setting out to achieve the right things, and that the methods being used to achieve these things are working. Within this arena, there has been emphasis on strategic planning activities. But operational management control systems have reduced the need for strategic planning. Indeed it has been long argued that distinct planning activities are not required at all. The function of control now becomes closely linked with planning, and it serves little purpose to conceive them as separate functions.

This implies that a strategic control process should set the agenda/goals for management processes, and monitor the operational activities delivering the result. An effective strategic control process needs both to communicate information about what outcomes need to be achieved, and be able to monitor how well these activities are working to achieve the strategic aims of the organisation.

Role of Strategic Control

When strategic control is undertaken properly, it contributes to the following specific areas:

- (i) *Measurement of Organizational Progress:* Strategic control determines organizational progress towards achievement of its objectives. When a strategy is chosen, it specifies the likely outcomes which are significant for achieving the organizational objectives. Measuring the success of strategy implementation is a prime concern for every strategist. The measurement of organizational progress is undertaken during the process of strategy implementation as well as after the implementation to ensure that remedial actions are taken at appropriate time.
- (ii) *Feedback for Future Actions:* Strategic control activities are undertaken in the light of criteria set by a strategic plan. But at the same time control provides inputs either for adjusting the same strategic plan or taking future strategic plan. The organizations take a strategic action implemented and observe its results. The results are in line with what was planned, similar types of strategic actions will be taken in future.
- (iii) *Linking Performance and Rewards:* Many organizations fail in linking performance and rewards. Linking performance and rewards is a big strategic issue. If taken objectively, control provides inputs for relating performance and rewards. Linking performance rewards is very important for motivating people in the organization so that the human talent can be reaped. A performance based motivations system works in a better way than one which considers factors other than performance.

Role of Organisational Systems in Strategic Control

Strategic control operates in the context of various organizational systems. It is observed that an organization develops various systems which help in integrating various parts of the organisation. The following are the major organizational systems:

- (i) *Information System:* Management information and control systems are closely interrelated, the information system is designed on the basis of control system. Every manager in the organization should have sufficient information about his performance, standards and his contribution for achieving the organizational objectives. Information system initiates that every manager is getting the required information. Broadly speaking, the manager should be supplied with the information for taking appropriate action. For taking corrective steps for the deviations, if any, the manager must have the information at proper time and covering the functioning of a period which is subject to control.
- (ii) *Planning System:* Planning provides the entire spectrum on which control

function is based. Control function emphasizes that there is a plan which directs the behaviour and activities in the organisation. Control measures these behaviour and activities and suggests measures to overcome the deviations if any. Since planning and control system are closely interlinked there should be proper integration of the two. These integration can be achieved by developing consistency of strategic objectives and performance measures.

- (iii) *Development System*: Development system is concerned with developing personnel to perform better in their existing position and likely future positions that they are expected to occupy. The system aims at increasing organization capability through people to achieve better results and later on these results becomes the basis for control.
- (iv) *Appraisal System*: Performance appraisal system involves systematic evaluation of the individual with regard to his performance and his potential for development. For evaluating an individual his performance along with his abilities and potential is taken into consideration.
- (v) *Motivation System*: Since the basic objective of the control is to ensure that organizational objectives are achieved, motivation plays crucial role in the control process. It energizes the managers and the other employees in the organization to perform better which is the key for organizational success.

Illustration:

Strategic control in Samsung

In the late 1980s, Samsung strengthened its environmental scanning system by appointing monitors for information in every business section and by introducing a system for collecting and disseminating information. Despite the delegation of administrative decision making to sub-units, the Headquarters has tightened its grip on strategic decisions. With the induction of a new president who is incharge of the integrated structure. The group chairman has 200 elite managers to supervise the group companies.

Feedback control

As regards feedback, Samsung has developed a highly formalized feedback control system. Reporting is comprehensive, evaluation is tough and the reward and punishment system is harsh. There are well established rules for performance evaluation. The reward and punishment is done in accordance with the rules. Until recently, there was an automatic deduction of bonus for poor performance. Most reporting is done by telephone or facsimile, but Samsung has introduced a global e-mail network. Informal communication system in Samsung is not strong since the Headquarter does not allow informal clans to develop.

Socialization Process

Samsung's Group recruitment system focuses on commitment, attitude and personality of the recruits. The shift in recruitment system is weakening the socialization of new recruits. The company has a well developed training and education system. Managers are expected to have some knowledge of everything

and detailed knowledge of something. The commitment of Samsung's managers is the highest among the Korean Electronic Companies because of fair reward system and high wage level.

Thus, Korean companies like Samsung with stronger formal control process have shown better performance compared to companies with stronger lateral control or no systematic control.

Source: Crafting and Executing Strategy: Concepts & Cases: Thomson, Arthur A. et. al

CONTROL PROCESS

The control process consists of the following steps:

(i) *Setting Performance Standards:* All functions in the organization begin with plans which specify the objectives and goals to be achieved. Based on this, standards are established which are criteria against which actual results are measured. For setting standards for control purpose it is necessary to identify clearly and precisely the results which are to be attained. After setting the standards it is also necessary to decide about the level of performance.

Standards are the levels of key variables that will be accepted as satisfactory. These standards may be of three types: pre-determined standards, historical standards, and external standards. Pre-determined standards are the goals set during the goal formulation process of a strategic management program. Historical standards are set by using past performance as a comparative base. Thus, current performance is compared with past performance. Historical standards are often used to evaluate performance. Use of historical standards is recommended only when it is determined that conditions have not changed so as to invalidate the trend and when prior performance is known to be acceptable. External standards refers to those whose values are derived from sources outside the organization or strategic business units. For example, management expectation, such as market share, return on assets, earnings per share etc. The shortcoming of this type of standard is the possible non-comparability of firms. Of these three types of standards, the one best suited for strategic management control purposes is predetermined standards.

(ii) *Measuring Actual Performance:* The next stage in control process is the measurement of actual performance against the standards already set. This involves measuring the performance in respect of a work in terms of control standards. The measurement of performance against its standards would be on a continuous basis so that deviations may be ascertained in advance of their actual performance and avoided by appropriate actions. Measurement of actual performance becomes an easy task if the standards are properly determined and the methods of measuring performance can be expressed explicitly.

(iii) *Comparison of Actual Performance against Standards:* This stage involves measuring actual key variable performance, comparing results against standards, and informing the appropriate people so that deviations can be detected and corrections made or reinforcement given. Financial or management accounting systems are usually relied on for measuring actual performance. However, many other measurement methods are also available, including product sampling, various predictions, observation by managers, meetings, and conferences. Whatever

measurement methods are selected, they should be timely, accurate, and cost effective. The need to inform people of measurement results necessitates a system of reporting.

(iv) *Analysing Variance*: Analysis of variance involves finding out the extent of variations and identifying the causes of such variations. When adequate standards are developed and actual performance is measured correctly the variations, if any, can be clearly identified. In case the standards are achieved no further managerial action is necessary and control process is complete. However, in many cases the actual performance achieved may vary from the standards fixed and variations may differ from case to case. When the variation between standard and actual performance is exceeded the prescribed level, an evaluation is made to find out the causes of such variations.

(v) *Re-enforcement of Corrective Action*: This step in the control process requires that action should be taken to maintain the decided degree of control into system or operation. The following actions are taken to maintain the control system:

- (a) Improvement in the performance by taking suitable measures if the result is not upto the desired level.
- (b) Resetting the standard of performance, if the standards are too high and unrealistic.
- (c) Change the strategies, objectives and plans, if they are not suitable.

Detection of negative deviations from standards usually leads to analysis of problems, decisions about how to correct them, and adjust to operations. Sometimes a control report will precipitate starting a new strategic management cycle. This new cycle may lead to the reformulation of goals or action plans, or both. Usually, however, strategies remain intact while operations are adjusted. The control process should be continuous so that control information is constantly fed back to the goal and action plan formulation stage. Deviations, therefore, should prompt immediate analysis so that a timely decision can be made about whether to change goals or action plans or operational management. It is also important to note that the performance which exceeds standards be reinforced. Too often management focuses attention only on negative deviations from expectations.

Guidelines for Proper Control

In designing control system, the top management should see that control should follow proper strategy. In this regard the following guidelines are recommended:

- (i) Control should involve only the minimum amount of information needed to give clear picture of events i.e., too many controls create confusion.
- (ii) Controls should monitor only meaningful activities and results; regardless of measurement difficulty.
- (iii) Controls should be timely so that corrective action can be taken before it is too late.
- (iv) Long-term and short-term controls should be used.
- (v) Controls should aim at pin pointing exceptions i.e., only those activities or results that fall outside predetermined tolerance range should call for action.

- (vi) Emphasize the reward of meeting or exceeding standards rather than penalizing for failing to meet standards.

STRATEGIC CONTROL TECHNIQUES

Strategy formulation is based on certain assumptions. In fact, there is a time gap between strategy formulation and its implementation. Sometimes the strategy formulated may not work effectively as devised by the strategists. In order to overcome this situation the following strategic control techniques are followed:

1. *Premise Control*: Premise control is designed to check systematically whether the assumptions set during strategy formulation and implementation process are still valid. Premises include assumptions or forecast of the future and known conditions that effect the operations of a strategy. Premises are usually concerned with environmental and industry factors. Environmental factors are—economic, political – legal, technological, socio-culture and global, which affect the operation of business organization. Any major change in these factors between the time of strategy formulation and its implementation necessitates a change in strategy. An industry factor affects the operation of business directly while formulating a strategy. So every organization makes assumptions about industry structure and the nature of competition it faces.

For effective premise control an organization may take into account the following measures such as:

- (i) Identify the key premises which are vital to strategy implementation.
- (ii) People in the organization who are likely to have access to the relevant information about the premises should be entrusted the responsibility for monitoring premises.
- (iii) Identify the trigger points at which a change in strategy is required.

2. *Strategic Momentum Control*: These techniques are suitable for organizations working in a relatively stable environment. The major assumptions made at the time of strategic formulation remain valid for quite long time. There may be change in the environmental factors but such change is gradual and on predicted lines. There are three approaches for strategic momentum control as under:

- (a) *Responsibility Control Centers*: Responsibility control centers are created on the basis of control criteria used and termed as revenue centers, expense centers, profit centers and investment centers.
- (b) *Underlying Success Factors*: The organization can achieve its objectives by focusing continuously on the success factors.
- (c) *Generic Strategies*: Generic strategic approach to strategic control is based on the assumption that an organization's strategy should be comparable with others in the same industry. Based on this, the organization can adjust its strategy.

3. *Strategic Leap Control*: Strategic leap control enables the organizations operating in a relatively unstable and turbulent environment in defining new strategic requirements and to cope with environmental realities. The following techniques are

generally used for exercising strategic leap control.

- (a) *Strategic Issue Management*: It involves identifying strategy issues and assessing their impact on the organization. By managing strategic issues in time, the organization can avoid the adverse impact on environmental surprises.
- (b) *Strategic Fitted Analysis*: It involves examining the nature and extent of synergies that can be developed in changing environment.
- (c) *Systems Modeling*: It refers to simulated technique of decision making in which various organizational features and environmental scenarios are analyzed on simulated basis.

4. *Implementation Control*: This is designed to assess whether the overall strategy should be changed in the light of unfolding events and the results associated with incremental steps and actions to implement the overall strategy. In designing implementation control, the following two aspects are taken in to consideration:

- (a) *Monitoring Strategic Thrusts*: For the implementation of strategy, actions are divided into different identifiable new thrusts. These thrusts provide information which can be used as basis for subsequent actions.
- (b) *Milestone Review*: It is an identifiable segment of a strategy which may be in the form of crucial events, major resource allocation over a passage of certain time. Each milestone requires critical assessment in terms of time and cost.

5. *Strategic Surveillance*: This is a non-focused control and is designed to monitor a broad range of events inside and outside the organization which are likely to threaten the course of strategy. The idea behind the strategy surveillance is that some form of general monitoring of multiple information sources should be encouraged with the objective to reveal unanticipated situations.

6. *Special Alert Control*: This measure is undertaken to assess the impact of any major environmental events such as technological invention, regional disturbance between countries affecting the business, strategic actions taken by a country or countries together in controlling some critical issues. For example, a sudden increase in critical resources may invite an immediate reassessment of the organization strategy.

Employees Responses to Control

Control systems themselves can trigger an array of human behaviors, some of which are positive in their impact on the organization and some of which are negative. Positive reactions such as voluntary compliance or even active acceptance can be expected when control criteria demonstrate relevance through operational significance and lead to results that can be: (i) affected by employees, and (ii) directly measured. Further, positive reactions to control can be precipitated by employee participation in the process of setting standards, especially when standards are perceived as achievable but not challenging.

Negative reactions to controls can take several forms. Employees can resort to fudging records or even sabotage in order to distort performance measurements

favorably. This results from lack of participation in the process of developing standards as well as misunderstanding of the importance of control.

A control system that emphasizes short-term results can jeopardize achievement of long-term goals. Failure to replace obsolete machinery may not only prevent short-term declines in return on assets but may also reduce long-term profitability. Absenteeism and turnover can be manifestations of tension and pressure caused by an overly strict control system.

Management Control versus Strategic Control

Several characteristics differentiate strategic control from other forms of control exercised by managers (e.g. the management of operational processes). For example, managers exercise strategic control when they work with an organisation to ensure that it achieves the strategic aims they have set for it. But to be able to do this the managers must have some discretion either to decide what needs to be achieved, or how to achieve it. Such discretion is not necessarily a characteristic of other management processes. These characteristic differences become significant when it comes to looking at the design of strategic management processes and support systems. There are two types of control processes that organisations use to monitor progress towards goals. Management control is used to track and respond to progress towards operational goals. Strategic control is used to track and respond to progress towards strategic goals. Strategic control can be thought of as activities primarily concerned with monitoring and controlling strategy implementation, part of which will be determining and calibrating the focus of related management control systems.

STRATEGIC CHANGE MANAGEMENT

Organisations are always involved in a variety of change, and this is not just confined to internal projects. For example, it could also encompass interaction with suppliers and customers. The change being undertaken by organizations now is inherently complex and often impacts diverse stakeholder groups both internally and externally. As the change portfolio grows the level of complexity grows with it. With many organizations now find it difficult to understand and track the plethora of change initiatives underway. An added complexity is a reduction in manpower and the availability of skilled resources.



In simple words, strategic change management is the process of delivering the strategy of an organisation in a controlled, efficient and effective manner.

It is not about the delivery of a single project or monitoring business as usual activities. It is basically the process of governing a portfolio of programmes, projects and initiatives within the context of a wider strategy for the organisation. The purpose of the whole exercise is to deliver value to the organization.

The term change refers to an alteration in a system whether physical, biological or social. Thus organization change is the alternation of work environment in the

organization. It implies a new equilibrium between different components of the organization i.e., technology, structural arrangement, job design, and people. An organization change may have following features:

- (i) Any change may effect the whole organization;
- (ii) When change occurs in any part of the organization, it disturbs the old equilibrium necessitating development of a new equilibrium;
- (iii) Organization change is a continuous process.

A strategic change is the movement of the company away from its present state towards some desired future state to increase its competitive advantage. There are three kinds of strategic changes that most of the companies pursue:

- (i) Re-engineering
- (ii) Restructuring; and
- (iii) Innovation.

They are explained herein below:

(i) Re-engineering: Business process re-engineering is the redesign of the business processes and the associated systems and organizational structures to achieve a dramatic improvement in business performance. The business reasons for making such changes could include poor financial performance, external competition, and erosion of market share of emerging market opportunities. Business process re-engineering is the examination and change of the business components such as: strategy, processes, technology, organization culture etc.

Strategic managers may need to develop a new strategy and structure to revise the level of their performance in the light of sudden changes taking place in the environment. They focus on business process, which is an activity that is vital to delivering goods and services to the customers.

(ii) Restructuring: Restructuring is another kind of change that strategic management use to implement strategic change to improve the performance. It may be: (a) reducing the level of differentiation and integration by reducing divisions, departments or hierarchy levels; (b) by reducing the number of employees to bring the operating cost. Restructuring also involves changes in relationships between divisions or functions. Restructuring and downsizing becomes necessary due to:

- Unforeseen changes in business environment;
- New technological development;
- Reduction in demand;
- Excess production capacity;
- High bureaucratic and operating costs;
- Improving the competitive advantage;

(iii) Innovation: Innovation is the process by which organizations use their skills and resources to create new technologies or goods and services so that they can change and better respond to the needs of their customers. Innovation can lead

organizations to change that they want, it can also lead to the kind of change, they do not want. Organizations that depend on innovation as the way to achieve competitive advantage should adopt adjustable structures such as matrix or cross-functional team-structures that give people freedom to experiment and be creative.

Factors in Organizational Change

Organization change is required to maintain equilibrium between various external and internal factors to achieve organizational goals. Therefore, the various factors necessitating organizational change may be: (i) external factors; and (ii) internal factors.

External Factors: Changes in social, political, economic, technological and legal environment, influence organizations to change themselves. Such changes may result in organizational changes like change in functions, production process, labour management relations, organizational methods, etc. In order to survive the changing environment, an organization must adopt change.

Internal Factors: Internal factors that necessitate a change may be due to change in managerial personnel and deficiency in existing organizational practices. Old managers are replaced by new ones due to retirement, promotion, transfer or dismissal. Each new manager brings his own ideas and methods of working in the organization. The relationships, more particularly informal one change because of changes in managerial personnel. Sometimes changes are necessary due to deficiency in the present organizational arrangements and processes. These deficiencies may be in the form of unmanageable span of management, large number of managerial levels, lack of co-ordination between various departments, difficulties in communication, multiplicity of committees, lack of informality in policy decisions, lack of co-operation between staff, etc.

Planned Change

Bringing change in a planned manner is the prime responsibility of all managers who are forward looking. It aims to prepare a total organization, or a major portion of it, to adapt to significant changes in the re-organization goals and direction. A planned change is a deliberate design and implementation of a structural innovation, a new policy or goal, or a change in operating philosophy, climate or style. Planned change attempts to the aspects of the organization which are closely interrelated i.e. technology, task, structure, people, etc.

Technology Related Changes: Technology refers to the sum total of knowledge providing ways to do things. It may include inventions and techniques which affect the way of doing things i.e. designing, producing and distributing products. It may include change, problem solving and decision-making procedures, introduction of automated data processing and changed methods of production.

Task Related Changes: A job consisting of several tasks may be designed in a number of ways ranging from job simplification to job enrichment. However, what alternatives are chosen must consider the core job characteristics i.e., skill variety, task identity, task significance, autonomy and feedback from the job. Task related changes must focus on high internal work motivation and high quality work performance.

Structure Related Changes: Structural changes redefine the nature of relationship among various organization positions and may include: (i) changing the number of hierarchical levels; (ii) changing one form of organisations to another form; (iii) changing span of management; and (iv) changing line-staff and functional authority.

People Related Changes: Changes in any type may require changes in people in an organization. These changes may be of skills and behaviour. The magnitude of these changes depends on the type of change.

Process of Strategic Change

Management of organizational change is a complex issue. It involves formidable exercise on the part of management. The various steps involved in a planned change, may include - identifying need for change, elements to be changed, planning for change, assessing change forces, actions for change and feedback.

(i) *Identifying Need for Change:* A change for the sake of change may produce strong resistance while useful necessary changes may get support from the people. There are various external forces necessitating change in an organization. Hence, the organization has to analyse how the change in external forces affect it. Identification of need for change depends on gap analysis i.e., gap between desired state of affairs and actual state of affairs, the difference between what the organization achieved and what it should achieve. The organization may go on changing its objectives over the period of time. Moreover gap analysis can be made on the basis of likely gap because any change in any factor affects the operation of the organization.

(ii) *Elements to be Changed:* While the process of identification of change will provide hints why change should take place, this stage takes the analysis further by diagnosing the problems caused because of which the change is necessary. Usually, change is required in three major elements of the organization i.e. organization structure, technology and people. The nature and extent of change in the elements will depend on the type being faced by the organization. Changes in organisation structure may include job design, basis of departmentation, span of control, organizational policies and procedures, coordination mechanism, power structure, etc. Technological changes include techniques for doing work, production methods, engineering process etc. Changes in people include changes in their behaviour, interaction pattern, information grouping, skills, attitudes, etc.

(iii) *Planning for Change:* Planning for change includes who will bring change, when to bring change and how to bring change. Every manager is a change agent who brings occasional changes in the areas of operation. However, major changes require that some persons are specified for the purpose. While deciding time element of change many factors have been considered such as, nature of forces which are likely to resist the change and the time taken to bring them to accept the change, time taken in training and development of people to make them more suitable for changed situation, time required to make resources available for a change, etc.

(iv) *Assessing Change Forces:* There are many forces - individuals, groups and even in the organization which resists change. Unless the co-operation of people is

not ensured it is difficult to implement the change process. For this purpose, the management has to create an environment in which the change will be accepted by the people. In any situation there are both driving and restraining forces which influence any change that may take place. Driving forces are those which affect a situation by pushing in a particular direction, tend to initiate a change and keep it going while restraining forces acting to restrain change or to decrease the driving forces. An equilibrium is reached when the sum of driving forces equals the sum of restraining forces. The management has to push driving forces and/or converting or immobilizing restraining process so that the people may accept the change.

Actions for Change: Actions for change consist of: unfreezing, changing and refreezing.

Unfreezing: Unfreezing is the process in which a person casts aside his old behaviour which might be inappropriate, irrelevant, or inadequate to the changing demands of the situation. This aspect of action is as important as the action relating to changing the target.

Changing: Changing is the stage at which individuals being changed to learn new behaviour i.e. methods of working, new thinking, perception of new roles, etc. The following guidelines have been suggested for an effective change in an organization:

- recognize that the primary purpose of change is to improve the results;
- make individuals responsible for their own change;
- encourage team performance and coordinated initiatives;
- encourage learning by doing;
- use positive energy, meaningful language and courageous leadership.

Refreezing: Refreezing means that what has been learned is integrated into actual practice. At this stage people internalise the new beliefs, feelings and behaviours learned during the changing phase. They adopt these elements as a permanent part of their behaviour gamut. It is possible that people will be prepared to take up a new pattern. It is also possible that they go back to the old one. The process of refreezing are necessary to consolidate a changed pattern.

(v) *Feedback:* Management of change requires feedback and follow-up of actions to ensure that the changed programme is going in the right direction without any adverse effect. As changed programming is likely to solve some problems and create new problems, it is desirable that management has a constant watch as the change program is in process. Problems occurred by the change should be rectified immediately so that it gives better results in the organization. Feedback received from changed programme may also be used to modify the subsequent programs.

Resistance to Change

In the process of strategic change, managers face the problem of resistance to change. People tend to resist many types of changes because it requires new habits or some sacrifices. Likewise social systems tend to resist change because of homeostasis, which implies self-correcting characteristics of human being to maintain equilibrium as a result of change. The reasons underlying resistance to change may be identified as individual resistance and group resistance.

Individual Resistance: There are many factors operating at the individual level which are responsible for resistance. Degree of resistance depends on how people feel about the change. Their feelings may be either real or emotional which may be seen in the context of economic; psychological and social factors.

Economic Factors: People feel attached to the organization for satisfying their needs. The economic needs i.e. physiological, job security, etc., precede over other needs. People may perceive that they will be adversely affected by the change in terms of their need satisfaction due to: (i) obsolescence of skill; (ii) fear of economic loss; and (iii) reduced opportunity for incentives.

Psychological Factors: It covers those factors which are based on people's emotions, sentiments and attitudes towards change. These are qualitative rather than quantitative. Major psychological factors responsible for resistance may include: ego defensiveness; status quo; low tolerance of change; lack of trust on change agent and fear of unknown.

Social Factors: People derive need satisfaction, particularly social needs through their mutual compatible interaction and form their own social groups at the workplace for the satisfaction of their social needs. The satisfaction of these needs is affected by a change which people resist. The major social factors causing resistance to change are: (i) desire to maintain existing social interaction; and (ii) feeling of outside interference.

Group Resistance: People may express their resistance in the form of group also. The effect of group as a source of resistance may be analysed in terms of nature of group dynamics and vested interests. Group dynamics refers to forces which operate in a group determining the behaviour of its members. These forces determine how effective a group would be in accepting or rejecting a change. The following nature of group dynamics is important in this context:

- If the group is highly cohesive and members have developed strong belongings to the group, it has strong say in acceptance or rejection of change.
- If both change agent and people are target for change belong to the same group, the role of group is more effective.
- The degree of group attractiveness to its members affect how effective the group is in change response.
- Group can exert more pressure on those factors of the members which are responsible for group being attractive to the members i.e., attitudes, values and behaviors.
- The degree of prestige of group determines the degree of influence the group has over the members and response to change.

In a group some people are more influential than others. These persons may use group as a means for satisfying their own needs. Thus, these vested interests try to influence group behaviour in the form of uniform response to a change based on the personal interest. This situation is common in case of labour unions.

Resistance of Organisation to Change

It is noticed that organization itself resists many changes due to reasons such as: counting past successes; stability of system, resource limitations, sunk cost and inter-organisational agreement.

Counting Past Successes: Past success stories may hinder to accept challenges of the changing environment. These organizations have achieved success by following a particular set of management practices so it is too rigid to accept the change.

Stability of Systems: A stabilized system derives many benefits and as such the organization may perceive the change as a threat to itself.

Resource Limitations: Organization has to adapt to its environment at its own costs. If the organization is not fully equipped for meeting its own cost, it may not be possible for it to bring necessary changes.

Sunk Cost: Many organizations have invested in various assets which can be used for specified period. Now if the change is required, these assets cannot be properly utilized. Normally organizations make a comparative study between the outcome of change programme and continuing with the old programme in the light of the sunk cost. Sunk cost can be in the form of people also.

Inter-organisational Agreement: In the interaction process, organization may enter into agreement with other organization over certain aspects of working. Hence, if any change is to be done, the other organization has also to be consulted. It is not necessary that the other organizations do agree with a change proposal.

Determining the Need for Strategic Change

Strategic managers are to determine the type and magnitude of change appropriate for an organization. Sometimes, this need is obvious when divisions are fighting or when competitors introduce a product which is clearly superior to the company. There are two main requirements of such an analysis:

- (i) *Assessing the Extent of Change:* Incremental strategic change is more common than transformational change within an organization. More often, managers find it difficult to determine that something is going wrong in the organization. Organizational problems may develop gradually for a number of years before they become evident. A state of strategic drift occurs when a company's strategic managers who are in a position to take action, recognise that the company performance is deviating from the actual performance. Measures such as decline in profitability, return on investment, stock price, or fall in market share, etc., indicate that there is need for a change.
- (ii) *Identifying Obstacles to Change:* The decision to restructure and right-size an organization needs the establishment of a new set of tasks and relationship among employees. The change may threaten the jobs of some employees. Therefore, they resist the change to take place. The identification of barriers to strategic change helps to decide what levers and mechanisms of change are likely to be useful. The cultural web can provide a framework for identifying the aspects of the organization that will tend to

preserve the current assumptions and ways of doing things. Routines, control systems, structures, symbols and power or dependency relationship can, therefore, be important blockages to change. However, the identification of such blockages can help to provide an agenda for considering appropriate mechanisms for change. Obstacles to change can be found at four levels in the organization i.e. corporate, divisional, functional and individual.

MANAGING STRATEGIC CHANGES

The basic problem in managing change is to overcome people resistance successfully. Problems of overcoming resistance to change can be managed in the following ways:

- (i) *Education and Communication:* If misinformation and lack of information create barriers to managing change, education and communication might be appropriate. It requires an atmosphere of mutual trust and confidence and respect between managers and employees.
- (ii) *Participation:* Participation helps to give people in organizational change a feeling of importance. It creates the feelings among the employees that the decision is their own. They realise that the change process is a must. Those people who are directly affected by the change should be given opportunity to participate in that change before the final decisions are reached.
- (iii) *Obtaining commitment:* Commitment to take part in changed programme can be obtained in private from each individual. However, getting a person to commit himself in private to a changed programme may yield fewer results than if he voluntarily and publicly gives his commitment to an idea of change.
- (iv) *Leadership:* A transformational leader can use personal reasons for change without arousing resistance. An effective leader tries to change the psychological needs of his followers.
- (v) *Training and Psychological Counselling:* Management can change the basic values of the people by training and psychological counseling. People should be educated to become familiar with change, its process, and working. They must be taught new skills, helped to change attitudes and indoctrinated in new relationships.
- (vi) *Coercion or Edict:* Coercion or edict is the imposition of change or the issuing of directives about change. It is the explicit use of power. Coercion is the least successful style of managing change except in a state of crisis or confusion.

Tactics of Change Management

Tactics refer to the specific measures or ways of action/management style to implement the change strategy. The common basic tactics for change are the following:

- (i) *Changes in Organization Routines:* Routines are the institutionalized ways of doing things. They tend to persist over time and guide people to do their

jobs. An organization that becomes especially good at carrying out its operations in particular ways achieve real competitive advantages, but there is also the risk that the same routines tend to block change and lead to strategic drift. They become powerful enough when required change in order to accommodate some new strategy.

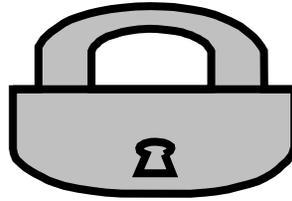
- (ii) *Symbolic Activity in Managing Change*: Change process may also be symbolic and symbolic acts and artifacts of an organization help to preserve the paradigm.
- (iii) *Selection Interviews*: While conducting interviews an indication may be given to the candidates and the nature of the organization and expectation from them.
- (iv) *Behaviour of Change Agents Themselves*: Behaviour of the change agents themselves is the most powerful symbol in relation to change. The behaviour, language and stories associated with such executives can signal powerfully the need for change and appropriate behaviour relating to the management of change. The behaviour of executives can also severely undermine change processes.
- (v) *Language Used by Change Agents*: The language used by change agents is also important in effecting change. Change agents use metaphor and symbolism is their language of change.

LESSON ROUND UP



- The implementation of policies and strategies is concerned with the design and management of systems to achieve the best integration of people, structures, processes and resources in reaching organization objectives.
- Developing alternative strategy and making the strategic choice constitute important steps in the process of strategic management.
- Strategy formulation requires good conceptual, integrative and analytical skills but strategy implementation requires special skills in motivating and managing others. Strategy formulation occurs primarily at the corporate level of an organization whereas strategy implementation permeates all hierarchy levels.
- Effective strategy implementation requires successfully managing action planning, organizational structure, human resources, annual business plan, monitoring and control, and the linkages.
- The important issues in the process of strategy implementation include- project implementation, procedural implementation, organizational structural and strategies, resource allocation, functional policies, communication strategy, leadership, challenges to change, etc.
- The McKinsey 7-S framework includes - strategy, structure, systems, style, skills, staff and shared values (super ordinate goals).

- Activation of strategy requires the performance of institutionalization of strategy, formulation of action plans and programmes, translating general objectives into specific objectives, and resource mobilization and allocation.
- Structural implementation involves designing of organizational structure and interlinking various departments and units of the organization created as a result of the organizational structure.
- The basic forms of organization structure are functional structure and divisional structure and these forms can further be supplemented by matrix organization, free form organization, etc.
- A procedure is a series of related task that make-up a chronological sequence and established way of performing the work to be accomplished. It involves completing the formalities such as licensing requirements, FEMA requirements, foreign collaboration procedures, capital issue requirements, import and export requirements, etc. prescribed by both Central Government and State Governments.
- Behavioral implementation is concerned with those aspects of strategy implementation that have impact on the behavior of the people in the organization such as leadership, organization culture, value and ethics, corporate governance, organizational policies , etc.
- Strategy implementation requires successfully formulating and implementing functional plans strategies for marketing, finance, personnel and union relation, research and development, production etc.
- A programme is a statement of the activities or steps needed to accomplish a single use plan. It may involve restructuring the organization, changing the company's internal culture, or beginning a new research effort.
- The elements of strategic programming covers- identification of mission, setting objectives, identifying alternative strategies, evaluation of strategies, selection of profit alternatives, preparation of master plans, preparation of medium and short term plans, and evaluation of results.
- Budget is a statement of a company's programmes in financial terms; it lists the detailed cost of each programme.
- Procedures are sequential steps or techniques that describe how a particular task or job is to be done.
- Strategic control involves the monitoring and evaluation of plans, activities, and results with a view towards future action, providing a warning signal through diagnosis of data, and triggering appropriate intervention by either tactical adjustments or strategic re-orientation.
- The control process consists of – setting performance standards, measuring actual performance, comparison of actual performance against standards, analyzing variance, and re-enforcement of corrective action.
- Strategic management always brings some changes in the organization, which needs to be managed effectively. A strategic change is the movement of the company away from its present state towards some desired future state to increase its competitive advantage. There are three kinds of strategic changes that most of the companies pursue, i.e. re-engineering, restructuring, and innovation.

SELF TEST QUESTIONS

1. Explain the concept of strategy formulation and strategy implementation.
 2. Discuss the factors that need to be taken care of while implementing strategy.
 3. What do you mean by strategy implementation? What are the issues involved in the process of strategy implementation?
 4. "McKinsey framework shows that there is a multiplicity of factors that influence an organization's ability to change". Discuss.
 5. Explain how strategy is activated?
 6. How does strategy affect organizational structure? Discuss the various forms of organizational structure. What is divisional structure? State the advantages and disadvantages of a divisional structure.
 7. What do you mean by procedural implementation? Discuss the steps involved in procedural implementation.
 8. Discuss the concept of behavioural implementation. State briefly the recent issues involved in behavioural implementation.
 9. Discuss the role of programs, budgets and procedures in implementing strategy.
 10. What do you understand by budgets? How budgets work as a tool for planning and controlling?
 11. What do you understand by strategic control? How it is different from management control?
 12. What are the various steps in control process?
 13. Explain different techniques of strategic control. How do these techniques differ depending on the environmental variability?
 14. "A strategic change is the movement of the company away from its present state towards some desired future state to increase its competitive advantage." Discuss.
 15. What do you understand by strategic change management? Why it is important for a strategist to understand the strategic change management process?
 16. Discuss the various steps involved in a planned change.
 17. What do you mean by resistance to change? Why do people resist change?
 18. Discuss the methods which can be used to overcome resistance to change.
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STUDY V PERFORMANCE EVALUATION

LEARNING OBJECTIVES



The object of this study lesson is to enable the students to:

- Understand the concept of performance evaluation
- Explain the measures of corporate performance
- Interpret the key financial indicators of performance evaluation
- Understand the concept of EVA and MVA and their use as performance evaluation tool.
- Evaluate the concept of balance scorecard and its uses as a management and control tool.
- Critically evaluate the procedures of evaluation of top management.
- Explain the performance of various responsibility centres.
- Understand the key performance indicators used in performance evaluation of different functions.
- Explain the process of benchmarking.

INTRODUCTION

Organizational control is the process whereby an organization ensures that it is pursuing strategies and actions which will enable it to achieve its desired goals. The measurement and evaluation of performance are the vital components of control. It poses the following basic questions :

- What was supposed to happen?
- What has happened?
- Why it has happened?
- Are the premises made during strategy formulation proving to be correct?
- Is it going to continue?
- What are we going to do about it?

The answer of the first question can be found from the plans. The second question can be answered by performance measurement. Management has to find far more useful information in order to answer the other questions. By finding out what has actually been happening, senior management can determine with

considerable certainty the direction in which the company is going on and, if every thing is going well as per the standard, continue with the existing activities. In case, if the performance measurements indicate that there are difficulties on the horizon, management may slightly change the procedure or even alter the course altogether.

A number of performance measures are available to record the success of the strategies followed. A company must select a range of performance measures which are appropriate for it. This selection should be made in the light of the organization's strategic intentions which have been formed to suit the competitive environment in which it operates and the nature of the business. If technical leadership and product innovation are the key source of a manufacturing company's competitive advantage, then it should measure its performance in this area relative to its competitors. But if a service provider decides to differentiate itself in the marketplace on the basis of quality of service, then, it should monitor other aspects such as customer satisfaction, employees' potential, etc., for maintaining the desired level of quality.

Irrespective of the type of company, i.e., manufacturing or the service sector, in choosing an appropriate range of performance measures, it will be necessary to balance them, to make sure that one dimension or set of dimensions of performance is not stressed to the detriment of others. While most companies will tend to organize their accounting systems using common accounting principles, they will differ widely in the choice, or potential choice of performance indicators.

Some of the important performance indicators used by the organization are competitive advantage; financial performance; quality of service; flexibility; resource utilization; innovation, etc. These measures reflect the success of the chosen strategy. Performance evaluation is necessary not only for judging the validity of strategies used but also for formulating future strategies.

Performance measurement includes the objective and subjective assessments of the performance of both organization and sub-units of an organization such as divisions or departments. Performance evaluation is the process of attaching value weights to various measures of performance to represent the importance of achievement on each dimension.

List out some of the performance indicators used by the organization?

Some of the important performance indicators used by the organization are:

- Competitive advantage;
- Financial performance;
- Quality of service;
- Flexibility;
- Resource utilization;
- Innovation.



MEASURES OF CORPORATE PERFORMANCE

Performance is the end result of activity. Measures to assess performance

depends on the organizational unit to be appraised and the objectives to be achieved. The objectives that were established in the strategy formulation should be used to measure corporate performance once the strategies have been implemented. Some measures, such as, return on investment (ROI) are appropriate for evaluating the company's or division's ability to achieve profitability objectives. This type of measure, however, is inadequate for evaluating additional objectives such as social responsibility or employee development. The major objective of the organization i.e., return on investment can be computed only after profits are computed for a period. It gives the picture of what has happened and not, what is happening or what will happen. A firm therefore, needs to develop measures that foresee likely profitability.

Controls can be established to focus either on actual performance results i.e. output or activities which generate the performance. Behaviour controls identify how things are done through policies, rules, standard operating procedures and orders from higher authorities. Output controls denote what is to be accomplished by focusing on the end result of the behaviours through the use of objectives and performance targets. Behaviour controls such as company procedures, getting work on time etc., are most appropriate when performance results are difficult to measure but the connection between activities and results is clear. Output controls, say, sales quotas, particular cost reduction, profit objectives, etc., are suitable when specific output measures have been agreed but the connection between activities and results is not clear.

Simple financial matters such as return on investment, earning per share, etc. are used to assess overall performance of the organization. However, a broad range of methods are recommended to evaluate success or failure of a strategy. Some of these methods are stakeholder measures, shareholder value and balanced score card approach. The current approach is towards more complicated financial measures and an increasing use of non-financial measures of corporate performance.

Earning Per Share (EPS)

It is the portion of a company's profit allocated to each outstanding number of shares. The profitability of a firm can be measured in terms of number of equity shares. This is known as earning per share. Thus, earning per share serves as an indicator of a company's profitability. It is calculated as:

$$= \frac{\text{Net Profit}}{\text{No. of Shares outstanding}}$$

In the EPS calculation, it is more accurate to use a weighted-average number of shares outstanding over the reporting term, because the number of shares outstanding can change over time. However, to simplify the calculation the number of shares outstanding at the end of the period is used.

An important limitation of EPS is that it ignores the capital that is required to generate the earnings (net income) in the calculation. Two companies could generate the same EPS number, but one could do so with less equity (investment) - that company would be more efficient at using its capital to generate income and, all

other things being equal. Investors also need to be aware of earning manipulations that will affect the quality of the earnings number. It is important not to rely on any one financial measure, but to use it in conjunction with financial statement analysis and other measures. It has several deficiencies as an evaluation of past and future performance. Since alternative accounting principles are used, EPS can have different but equally acceptable values, depending on the principle selected for its computation. Further, EPS is based on accrual income; the conversion of income to cash can be near term or delayed. Therefore, EPS does not consider the time value of money. An increase in EPS does not necessarily refer to the increase in profitability. This kind of increase in EPS is erroneous in the sense that the real earnings have not increased.

Return on Investment (ROI)

A performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments. This is the most commonly used measure of corporate performance in terms of profits. The profitability of a firm can be analysed from the total funds employed in the firm. This means the long-term sources of funds. Thus, it is the result of dividing net income before taxes by total value of investments. It is calculated as follows:

$$\text{Return on Investment} = \frac{\text{Net Operating Profit}}{\text{Total Investment}}$$

Return on investment is a very popular measure because of its versatility and simplicity. That is, if an investment does not have a comfortable return on investment, or if there are alternative opportunities with a higher return on investment, then the investment should not be undertaken. For example, a marketer may compare two different products by dividing the revenue that each product should generate by taking into account its respective expenses. A financial analyst, however, may compare the same two products by using an entirely different return on investment calculation, i.e. by dividing the net income of an investment by the total value of all resources that have been employed to make and sell the product.

This flexibility has a downside, as return on investment calculations can be easily manipulated to suit the user's purposes, and the result can be expressed in many different ways. When using this measure, make sure you understand what inputs are being used.

Return on Equity (ROE)

A measure of a corporation's profitability reveals how much profit a company generates to the shareholders. Return on equity is calculated as:

$$= \frac{\text{Net Income}}{\text{Shareholders' Equity}}$$

It is also known as "return on net worth (RONW)". The return on equity is useful for comparing the profitability of a company to that of other firms in the same industry.

Dividing net income by total equity has also its limitations since it is derived from

accounting based data. In addition, earnings per share and return on equity are unrelated to a company's share price. Because of these and other limitations, earning per share and return on equity by themselves are not adequate measures of corporate performance.

There are several variations on the formula that investors may use:

1. Investors wishing to see the return on common equity may modify the formula above by subtracting preference dividends from net income and subtracting preference shares from shareholders' equity, giving the following:

$$\text{Return on Equity} = \frac{\text{Net income} - \text{Preference dividends}}{\text{Equity shares}}$$

2. Return on equity may also be calculated by dividing net income by average shareholders' equity. Average shareholders' equity is calculated by adding the shareholders' equity at the beginning of a period to the shareholders' equity at the end of the period and dividing the result by two.

Market Value Added (MVA)

Market Value Added (MVA) measures the share market; estimate of the net present value of firm's past and expected capital investment projects. It is the difference between the current market value of a firm and the capital contributed by investors. Market Value is the estimated amount for which a property should be exchanged on the date of valuation between a willing buyer and a willing seller in an arms-length transaction after proper marketing wherein each part had acted knowledgably, prudently, and without compulsion. The higher the MVA, the better. A high MVA indicates that the company has created substantial wealth for its shareholders i.e., if MVA is positive, the firm has added value and if it is negative, the firm has destroyed value. The amount of value added needs to be greater than the firm's investors could have achieved investing in the market portfolio, adjusted for the leverage of the firm relative to the market.

The formula for MVA is:

$$\text{MVA} = V - K$$

Where:

- MVA is market value added
- V is the market value of the firm, including the value of the firm's equity and debt.
- K is the capital invested in the firm.

Thus, it is calculated as follows:

- (i) Add all the capital that has been put into a company i.e. a share capital, loan capital and retained earnings.
- (ii) Re-classify certain accounting expenses, such as research and development to reflect that they are actually investments in future earnings. This gives the firm's total capital.

- (iii) Using the current share price, the total value of all outstanding shares, adding to the company's debt. This is the company's market value. If the company's market value is greater than all the capital invested in it, the firm has a positive MVA, meaning that management has created wealth. However, if the market of the company is less than the capital than the shareholders' wealth is being destroyed.

Economic Value Added (EVA)

Economic Value Added is a popular method of measuring corporate and divisional performance. In corporate finance, Economic Value Added is the net earning in excess of charge (cost) for the capital employed (debt + equity) by lenders and shareholders. The organization or firm is said to have earned an economic return if its after tax return on capital employed (ROCE) exceeds, the cost of capital employed (COCE).

Thus, Economic Value Added measures the difference between the pre-strategy and post-strategy value of the business. In other words, EVA is after tax operating profit less the total annual cost of capital. The annual cost of borrowed capital is the interest charged by the firm's banks and bondholders. A company's overall cost of capital is the weighted-average cost of the firm's debt and equity capital. The total amount of capital invested by the business includes investments in buildings, machine, investments etc. In order to find out the annual cost of capital, multiply the firm's total capital by the weighted average cost of capital. To calculate EVA compare the figure of after tax operating earnings with annual cost of capital. If the difference is positive, the strategy is generating value for the shareholders and if it is negative the strategy is reducing shareholders value.

It is calculated as follows:

$$\text{EVA} = \text{Net Operating Profit After Tax} - \text{Cost Charges for Capital Employed}$$

Cost charges for the capital employed is the Weighted Average Cost of Capital (WACC) which is what a company is expected to pay to finance its assets. WACC is the minimum return that a company must earn on existing asset base to satisfy its creditors, owners, and other providers of capital and capital employed represents the total cash investment that shareholders and debt holders have made in a company.

EVA in an organization will increase in the following situations :

- (i) If operating profits grow without employing additional capital i.e., through greater efficiency;
- (ii) If additional capital is invested in the projects that gives higher returns than the cost of procuring new capital; and
- (iii) Unproductive capital is liquidated, curtailing the unproductive uses of capital.

In the field of corporate finance, economic value added is a way to determine the value created, above the required return, for the shareholders of a company.

Shareholders of the company will receive a positive value added when the return from the capital employed in the business operations is greater than the cost of that

capital. Any value obtained by employees of the company or by product users is not included in the calculations.

EVA could be misleading as a wealth measure because it reflects momentary swings in the capital markets rather than inherent company performance. EVA is also shareholder centric and hence of little relevance to the rest of the stakeholders.

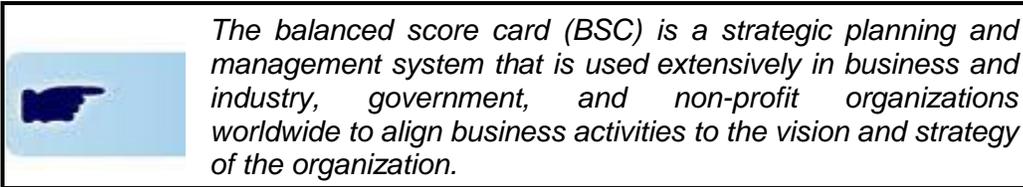
Stakeholder Measures

Each stakeholder has his own set of criteria to determine how well the company is performing. These criteria deal with direct and indirect impact of corporate activities on stakeholders interests. The management should establish the following possible short-term measures as well as long-term measures for each stakeholder category so that it can keep track of stakeholders concern :

Stakeholder Category	Possible Short-term measures	Possible Long-term measures
Customers	Sales in rupees and volume New customers and their needs.	Growth in sales Turnover of customer base Ability to control price.
Suppliers	Cost of raw material Delivery time Availability of raw material.	Increase in- raw-material cost Delivery time New ideas from suppliers.
Employees	Number of suggestions Productivity Number of grievances.	Number of promotions Labour turnover.
Financial Institutions	Earning per share Share price Return on equity.	Convince stock market Growth in return on equity
Government	Number of new legislations that affect the firm Access to key members and staff.	Number of new legislations that affects industry.

Shareholder Value

The real shareholder value can be defined as the present value of the anticipated future stream of cash flows from the business plus the value of the company if liquidated. As the company is to increase shareholders wealth, shareholder value analysis concentrates on cash flow as the key measure of performance. The value of a company is thus, the value of its cash flows discounted back to their present value, using the company's cost of capital as the discount rate. As long as the returns from a business exceed its cost of capital, the business will create value and be worth more than the capital invested in it.

BALANCED SCORE CARD APPROACH

The BSC provides for the development of a conceptual framework model which assigns the strategic mission of the organization with achievable goals and actions measured against pre-determined metrics. It helps to improve internal and external communications, and monitor organization performance against strategic goals. It was originated as a performance measurement framework which added strategic non-financial performance measures to traditional financial measures to give managers and executives a more balanced view of organizational performance.

It was originated by Drs. Robert Kaplan (Harvard Business School) and David Norton as a performance measurement framework that added strategic non-financial performance measures to traditional financial metrics to give managers and executives a more 'balanced' view of organizational performance. However, the phrase balanced scorecard was coined in the early 1990s, the roots of the this type of approach are deep, and include the pioneering work of General Electric on performance measurement reporting in the 1950's and the work of French process engineers (who created the *Tableau de Bord* – literally, a "dashboard" of performance measures) in the early part of the 20th century.

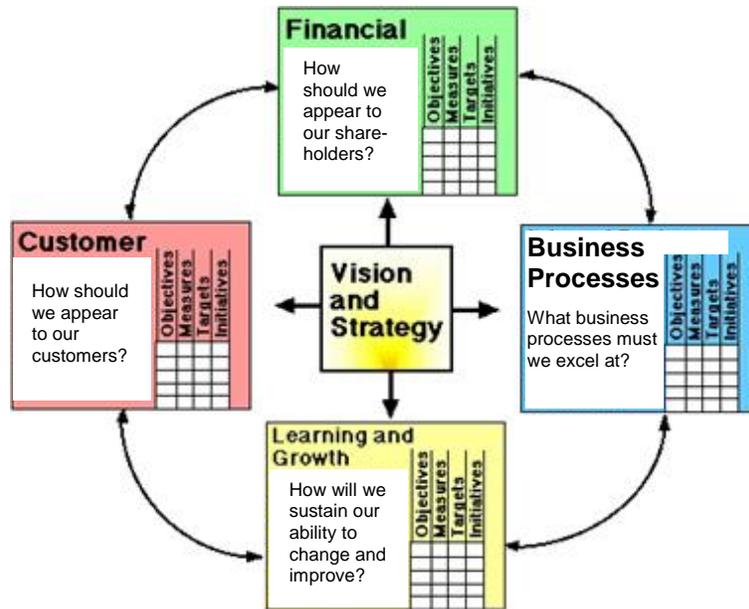
The balanced scorecard has evolved from its early use as a simple performance measurement framework to a full strategic planning and management system. The "new" balanced scorecard transforms an organization's strategic plan from an attractive but passive document into the "marching orders" for the organization on a daily basis. It provides a framework that not only provides performance measurements, but helps planners identify what should be done and measured. It enables executives to truly execute their strategies.

A balanced score card combines financial measures which describe the results of actions already taken with operational methods on customers' satisfaction, internal processes, and the company's innovation and improvement activities for future financial performance. The management should develop goals or objective in financial; customer; internal business perspective; and innovation and learning areas. Objective in each area is then assigned one or more measures, as well as a target and an initiative. These measures can be treated as key performance measures which are essential for achieving a desired strategic option.

The balanced scorecard has evolved as a simple performance measurement framework to a full strategic planning and management system. It transforms an organization's strategic plan from an attractive but passive document into the marching orders for the organization on a daily basis. It provides a framework that not only provides performance measurements, but also helps planners to identify what should be done and measured. It also enables executives to truly execute their strategies. It provides a clear prescription as to what companies should measure in order to balance

the financial perspective. The balanced scorecard is a management system (not only a measurement system) which enables organizations to clarify their vision and strategy and translate them into action. It provides feedback around both the internal business processes and external outcomes in order to continuously improve strategic performance and results. When fully deployed, the balanced scorecard transforms strategic planning from an academic exercise into the nerve center of an enterprise. The balanced scorecard retains traditional financial measures.

The balanced scorecard suggests the following four perspectives:



The Balanced Score Card – Perspectives

(i) Learning and Growth Perspective

This perspective includes employee training and corporate cultural attitudes related to both individual and corporate self-improvement. In a knowledge based organization, people; the only repository of knowledge are the main resource. In the current situation of rapid technological change, it is becoming necessary for knowledge workers to be in a continuous learning mode. Government agencies often find themselves unable to hire new technical workers, and at the same time, there is a decline in training of existing employees. This is a leading indicator of brain drain that must be reversed. Metrics can be put into place to guide managers in focusing training where they can help the most. In any case, learning and growth constitute the essential foundation for success of any knowledge-based organization.

(ii) Business Processes Perspective

This perspective refers to internal business processes. Metrics based on this perspective allow the managers to know how well their business is running, and whether its products and services conform to customer requirements. These metrics have to be carefully designed by those who know these processes most intimately; with unique missions, these are not something which can be developed by outside consultants.

In addition to the strategic management process, two kinds of business processes may be identified: (a) mission-oriented processes, and (b) support processes. Mission-oriented processes are the special functions of government offices, and many unique problems are encountered in these processes. The support processes are more repetitive in nature and hence easier to measure and benchmark using generic metrics.

(iii) Customer Perspective

Recent management philosophy has shown an increasing realization of the importance of customer focus and customer satisfaction in any business. These are leading indicators, if customers are not satisfied, they will eventually find other suppliers that will meet their needs. Poor performance from this perspective is thus a leading indicator of future decline, even though the current financial picture may look good. In developing metrics for satisfaction, customers should be analyzed in terms of kinds of customers and the kinds of processes for which we are providing a product or service to those customer groups.

(iv) Financial Perspective

The availability of timely and accurate financial data will always be a priority, and managers will do whatever necessary to provide it. In fact, often there is more than enough handling and processing of financial data. With the implementation of a corporate database system, it is seen that more of the processing can be centralized and automated. But the current emphasis on financial parameters only may lead to the unbalanced situation with regard to other perspectives. There is a need to include additional finance-related data, such as risk assessment and cost-benefit data, in this category.

EVALUATING TOP MANAGEMENT

Many organizations realize that it is important for the company to have a good management team. The problem of evaluating management is a difficult exercise because many aspects of the job are intangible. It's clear that investors can't always depend on companies' disclosure by only perusing and analyzing financial statements. Fallouts such as Enron, WorldCom and Lehman Brothers have demonstrated the importance of emphasizing the qualitative aspects of a company's financial statements. There is no magic formula for evaluating management performance, but there are factors to which attention should be given.

The Board of Directors closely evaluates the job performance of the CEO and the top management team by a strategy of management audit. It is basically concerned with overall corporate profitability as measured quantitatively by return on investment, return on equity, earning per share and shareholders value. Any absence of short-term profitability naturally creates trouble to the CEO. The Board of Directors, however, are also concerned with other factors. It is of the view that a CEO's ability to establish strategic direction, build management team and provide leadership is more critical in the long run than few quantitative measures. The Board of Directors evaluates top management on the typical output oriented quantitative measures as well as the behavioural measures i.e. factors relating to its strategic management practices. The estimation of CEO's performance is comparatively less in most of the companies. The specific items to be evaluated by the board on the top

management should be derived from the objectives agreed upon by the Board and top management.

Management audit is very useful to the Board of Directors for evaluation of various corporate activities performed by management. It is developed to evaluate activities such as corporate social responsibility, functional areas such as marketing, international trade and to evaluate the corporation itself in a strategic audit.

JOB OF MANAGEMENT

A strong management is the back-bone of any successful organization. This is not to say that employees are not so important, but it is management that ultimately makes the strategic decisions. One can consider management as the captain of a ship. Theoretically, the management of a publicly traded company is in charge of creating value for shareholders. Management has to run a company in the interest of the owners. Of course, it is unrealistic to believe that management only thinks about the shareholders. Managers are people, like anybody else, looking for personal gain. So, problems arise in the situations when the interests of the managers are different from the interests of the shareholders. The theory behind this tendency is called agency theory, which says that conflict will occur unless the compensation of management is related somehow with the interests of shareholders. Don't be naive by thinking that the board of directors will always come to the shareholders' rescue. Management must have some actual reason to be beneficial if shareholders are being benefited due to the following aspects :

Stock Price: It is said that qualitative factors are pointless because the true value of management will be reflected in the bottom line and the stock price. It is true in the long run, but strong performance in the short run doesn't guarantee good management. The best example is the downfall of dotcoms. For a period of time, everybody was talking about how the new entrepreneurs were going to change the rules of the business. The share price was deemed as a sure indication of success. The market, however, behaves strangely in the short term. Strong stock performance alone doesn't mean that you can assume that the management is acting professionally and of high quality.

Length of Tenure: One good indicator of good performance is how long the CEO and top management has been serving the organization.

Illustration:

General Electric Company whose former CEO, Jack Welch, was with the company for around 20 years before he retired. Many considered him as one of the best managers of all time.

Strategy and Goals: Analyse, what kind of goals has the management set out for the organization? Whether the company has a mission statement? How effective is the mission statement? A good mission statement creates goals for management, employees, stockholders and even partners.

Insider Buying and Buyback of Shares: If insiders are buying shares in their own companies, it's usually because they have information which is not available to normal investors. The key issue here is to pay attention to how long the management

holds shares. Keeping shares to make a quick buck is one thing; investing for the long term is another.

Illustration:

Bill Gates: although he sells to diversify, a large portion of his wealth is held in Microsoft stock.

The same can be said for buyback of shares. Buyback of shares is the logical use of a company's resources. After all, the goal of a firm's management is to maximize return for shareholders. A buyback increases shareholder value if the company is truly undervalued.

Compensation: High-level executives draw comfortable package. Good management pays for itself by increasing shareholder value. But to determine the level of compensation is a difficult thing. One thing to consider is that managements in different industries take in different amounts. As a general rule, it must be desired that CEOs in the same industries have similar compensation.

It is suspicious if a manager makes large amount of money while the company suffers. If a manager really cares about the shareholders in the long term, it should not happen. It all comes down to the agency problem.

The facility of stock options is a prominent method of compensation to employees. This option is the solution to ensuring that management increases shareholder value. The theory sounds good, but doesn't work as well in reality. It's true this scheme provides compensation to performance, but not necessarily for the benefit of long-term investors. Many executives simply did whatever it took to drive up the share price so that they could vest their options to make quick money. Investors then realized that the books had been overlooked, so share prices plummeted back down while management made good money. Also, stock options aren't free, so the money has to come from somewhere, usually the dilution of existing shareholder's stock.

MEASURING DIVISIONAL PERFORMANCE

Responsibility centers are used to isolate a unit so that it can be evaluated separately from the rest of the corporation. Each responsibility centre has its own budget and is evaluated on its use of budgeted resources. Responsibility centre is headed by the manager responsible for the center's performance. Each centre uses resources to produce goods or services.

A firm may use different divisional formats like cost centre, revenue centre, profit centre, investment centre, expense centre, etc., for the purpose of the performance measurement of various divisions and can use different evaluation criteria suitable for a particular divisional format. The counter productive incentives induced by these performance measures and the conditions under which each of them could be sensibly used in an organization are analyzed as under:

(i) Standard Cost Centers: Cost centres are divisions which add to the cost of the organization, but only indirectly add to the profit of the company. It is primarily used in manufacturing organization.



Standard cost is computed for each operation on the basis of historical data in evaluating the center's performance. Standard cost for each unit when multiplied by the number of units produced result in the expected cost of production which is compared with actual cost.

Organization may choose to classify business units as cost centres, profit centres, or investment centres. There are some significant advantages for classifying divisions as cost centres, since cost is easy to measure. However, cost centres create incentives for managers to under fund their units in order to benefit themselves, and this under funding may result in adverse consequences for the organization as a whole, for example, reduced sales because of bad customer service.

Since the cost centre has a negative impact on profit, it is a likely target for rollbacks and layoffs when budgets are cut. Operational decisions in a cost centre, for example, are typically driven by cost considerations. Financial investments in new equipment, technology and staff are often difficult to justify to management. It is because indirect profitability is hard to translate to bottom-line figures. Business metrics are sometimes employed to quantify the benefits of a cost centre and relate the costs and benefits to those of the organization as a whole.

(ii) Profit Centers: Performance is measured in terms of difference between revenue and expenditures. A profit centre is established when an organization unit has control over both its resources and its products or services. By having a profit centre, a company can be organized in divisions or separate product lines. The manager of each division is given autonomy to the extent that is able to keep satisfactory profits level. Profit Centers are part of an organization which directly adds to its profit. Managers are held accountable for both revenues, and costs (expenses), and therefore, profits. Different profit centers are separated for accounting purposes so that the management can follow how much profit each center makes and compare their relative efficiency and profit.

Examples of typical profit centers are a store, a sales organization and a consulting organization.

There are several advantages of profit centre approach.

- (a) it constitutes a combined measure of both effectiveness and efficiency.
- (b) it provides an excellent training ground for management and excellent means for evaluating divisional managers' potential for higher management job.

(iii) Revenue Centers: Production is usually measured in terms of units or sales in rupees without consideration of the cost incurred. This centre is judged in terms of effectiveness rather than efficiency. The effectiveness of sales is determined by comparing its actual sales to its projected sales.

Revenue Centers are the logical complement to a cost center. The performance measure in such centers is total revenue and they have many of the same features

as cost centers. They can take one of three logical forms:

- (a) Maximize total revenues for a given price.
- (b) Maximize total revenues for a given quantity of unit sales.
- (c) Maximize total revenues (with no quality constraint).

The first two options are logically the same, and for the correct choice of price or quantity, are consistent with maximizing the value of the firm. The revenue center manager cannot be allowed to determine the quantity or he will simply go to the quantity where revenue is maximized.

As long as marginal costs are positive, it will lead to profit maximization. The product mix decision in a particular situation is taken due to additional revenue from different product lines. If so, other things being equal, the manager will substitute sales efforts from lower priced to higher priced products for overall profits to the organization. In this situation, a better performance measure is gross margin defined as the difference between total revenues and total variable costs. The advantage of the revenue center is that the manager can specialize on the marketing and sales effort without concern for the factors which influence the production cost. To do so, the manager will generally be given authority over those issues involving marketing and sales which require considerable knowledge that is specific to the local level but not the authority to decide on quantity or product mix.

(iv) Investment Centres: Large manufacturing organizations assign significant assets to make their products, resulting that their asset base should be subject to performance evaluation. An investment centre performance is measured in terms of difference between its resources and its product or services. The most widely used measure of investment centre performances is return on investment. Investment center is a unit within an enterprise, the performance of which is measured against use of its capital, as opposed to a cost or profit center, which are measured against raw costs or profits.

Investment centers are a variation on the profit center structure in which the manager is evaluated on the relation between profits and the assets used to generate them. They tend to be desirable when the profit center manager is given decision control over the amount of assets used in the activity and when the costs associated with asset utilization are important. Investment centers are performance measurement systems which take into account the efficiency of asset utilization. They are important in situations: (a) when the managers of the division have the specific knowledge required to decide on the optimal level of investment, and are given or acquire decision rights over investment and asset levels, and (b) when the costs of asset utilization are important. It has historically been common for organizations to take asset utilization into account by using rate of return measures such as return on assets or return on equity. Both of these measures are highly susceptible to gaming and tend to provide counter productive incentives when managers have decision rights over the level of investment or assets. Again, the objective function in an investment center can take one of three forms:

- (i) Maximize the percentage return on assets.
- (ii) Maximize total assets for given total percentage return.

- (iii) Maximize total percentage return on assets (with no constraint on total assets).

Forms (i) and (ii) can be consistent with maximizing the value of the firm if the constraints on total assets or total percentage return are chosen correctly. This can work if top management has the relevant specific knowledge to set the correct constraints. However, a common form for this objective function is to take the unconstrained version (iii) and this is inconsistent with maximizing the value of the firm.

A manager evaluated on maximizing the total percentage return on assets has incentive to reduce assets to the point where the firm owns no assets other than the single asset whose returns are the greatest. This, of course, is not consistent with maximizing value or wealth. A 100% return on ₹1,000 of assets is ₹1,000, while a 30% return on ₹100,000 of assets is ₹30,000.

(v) Expense Centres: Resources are measured in terms of rupees without consideration for product or service cost. The budgets have been prepared for those costs that can be calculated and can be estimated. This division generally produces services for the rest of the organization. The provision of internal administrative services such as, human resources, patent and public relations services, administrative service, and research facilities, are commonly organized as expense centers.

CHOICE OF PERFORMANCE MEASURE

The choice of a performance measure requires a theory which predicts when one performance measure will dominate another. The determinants of performance measurement enable one to predict when a division will be organized as a profit center, cost center, investment center, revenue center, or expense center. The choice between an expense center and the other options is essentially the choice over whether to monitor the division directly from higher in the hierarchy. This option will be more attractive when it is easier to evaluate the performance of the division from higher levels of the hierarchy. When it is difficult to decentralize the monitoring function to users of the output of the division, it is difficult to identify a set of users who could be charged for the output of the unit. Such users must be individuals whose valuation of the center's output is equal to the value of the organization as a whole.

In general, a cost center will be more desirable at lower cost of obtaining good information on quantity, quality, correct output mix, cost functions. Profit centers will tend to be more desirable at higher the costs and the easier it is to identify the correct revenues for the division. Profit centers will tend to work best when they are combined with a right assignment. It decentralizes part of the monitoring function of the center to its customers through a chargeback system which gives those customers effective alternatives and thereby provides potential or actual competition for the profit center.

Investment centers and EVA will tend to be more desirable when more capital intensive is an activity and the harder it is to identify optimal divisional asset investments from higher hierarchy.

EVALUATING FUNCTIONAL PERFORMANCE

In order to measure the performance of different functions in the organization certain key performance indicators (KPIs) are identified for each function and their values are measured and compared with the planned one to find out deviations, if any. The key performance indicators related to different functions of business organizations are discussed as under :

Manufacturing and Production Key Performance Indicators

Volume, variety and complexity of managerial issues surrounding the production process make the area of corporate activity a particularly rich one for non-financial indicators. Performance indicators can be devised for all operational areas, depending on the exact nature of the production process, including the following:

- Indicators deriving from time and motion studies
- Production line efficiency
- Ability to change the manufacturing schedule when the marketing plan changes
- Reliability of component parts of the production line
- Production line repair record
- Keeping failures of finished goods to a minimum
- Ability to produce against the marketing plan
- Product life cycle
- Indicators concerned with controlling production quality
- Measurement of scrap
- Tests for components, sub-assemblies and finished products
- Fault analysis
- Most likely reasons for product failures
- Actual failure rates against target failure rates
- Complaints received against the quality assurance testing programme
- Annualized failures as a percentage of sales value
- Failures as a percentage of units shipped
- Various indicators of product/service quality.

Indicators concerned with the purchasing department's external relationships with its suppliers includes:

- Inventory levels and timing of deliveries
- Just in time inventory control measurements
- Stock turnover ratio
- Suppliers delivery performance
- Analysis of stock-outs
- Parts delivery service record
- Percentage of total requests supplied in time
- Percentage supplied with faults.

Indicators of sales delivery and service:

- Shipments and first request date
- Average number of days shipments late
- Response time between enquiry and first visit

Human Resource Key Performance Indicators

This includes the following:

- Head count control
- Head count by responsibility
- Mix of staff analysis
- Mix of business analysis and staff personnel needs
- Skilled and non-skilled staff
- Management personnel's vs. operations staff
- Own labour/outside contractor analysis
- Workload activity analysis
- Vacancies existing and expected
- Labour turnover
- Labour turnover vs. local economy
- Percentage of overtime worked to total hours worked
- Absence from work
- Staff morale
- Cost of recruitment
- Number of applicants per advertisement
- Number of employees per advertising campaign
- Staff evaluation techniques
- Evaluation of staff development plans
- Monitoring of specific departments, e.g. accounting
- Accuracy of reporting as measured by wrong-allocations and wrong-postings
- Monitoring of departments long-term performance
- Pay and conditions vs. competition.

Research and Development Key Performance Indicators

It may cover the following:

- Evaluation and basic research and development objectives, strategic objectives and project objectives
- Product improvement against potential market acceptance
- Research and development against technical achievement criteria against cost and markets

- Research and development priority vs. other projects
- Research and development vs. competition
- Research and development technical milestones
- Analysis of market needs over the proposed product/service life of R&D outcome
- Top management audit of research and development projects
- Major programme milestones
- Failure rates of prototypes
- Control by visibility - releases, e.g. definition release, design release, trial release, manufacturing release, first shipment release, research and development release.

Marketing Key Performance Indicators

Among the marketing KPIs, top management analyzes the following customer related numbers :

- New customers acquired.
- Status of existing customers.
- Turnover generated by segments of the customers.
- Outstanding balances held by segments of customers and terms of payment.
- Collection of bad debts within customer relationships.
- Demographic analysis of individuals' potential customers applying to become customers, and the levels of approval, rejections and pending numbers.
- Delinquency analysis of customers behind on payments.
- Profitability of customers by demographic segments and segmentation of customers by profitability.

Many of these aforementioned customer KPIs are developed and improved with customer relationship management. In addition to above, certain other commonly used indicators in marketing are:

- Measurements based on staying close to the customer
- Complaints re-manuals
- Complaints re-packaging/ease of opening
- Quality of packaging materials
- Customer satisfaction analysis
- Price of products comparisons
- Monitoring repeated lost sales by individual salesmen
- Sales commission analysis
- Monitoring of enquiries and orders
- Strike rate - turning enquiries into orders
- Analysis of sales by product line, geographical area, individual customer, and salesmen

- Matching sales orders against sales shipments - the trend from the mismatch
- Backlog of orders analysis
- Flash reports on sales
- Publication of sales teams performance internally
- Analysis of basic salaries and sales commissions
- Share of the market against competitors
- Share of new projects in the industry
- New product/service launch analysis
- Time to turn round repairs
- Delays in delivering to customers (customer goodwill)
- Value of warranty repairs to sales over the period.

Environment related Key Performance Indicators

This covers the following:

- Work place environment yardsticks
- Cleanliness
- Tidiness
- Catering facilities vs. competition
- Other facilities vs. competition etc.

BENCHMARKING TO EVALUATE PERFORMANCE

Benchmarking is the continuous process of measuring products, services and practices against the competitors and those companies recognized as industry leaders. It is based on the concept that it makes no benefit to reinvent something that someone else is already using. It involves open learning how others do something better than one's own company so that one not only can intimate, but perhaps even improve on their current technique. The benchmarking process normally includes the following steps:

- (i) Identify the area or process to be examined.
- (ii) Find behavioural and output measures of the area or process and obtain measurements.
- (iii) Select an accessible set of competitors and best-in-class companies against which to benchmark.
- (iv) Calculate the differences among the company's performance measurements and those of the best-in-class and determine why the differences exist.
- (v) Develop tactical programs for closing performance gaps.
- (vi) Implement the programs and then compare the resulting new measurements with those of the best-in-class companies.

Benchmarking has been found to produce best results in companies which are already well managed. Basically, the poor performing companies tend to be overwhelmed by the discrepancy between their performance and the benchmark—and tend to view the benchmark as difficult to reach.

Illustration:**Xerox embarking Benchmarking Process**

Xerox pioneered the case of benchmarking when Japanese manufacturers began selling midsize copiers in the United States at less than the Xerox production cost. To handle this problem, Xerox sent a team of line managers to Japan to study competitor's business processes and cost. It sought the help of Fuji-Xerox who was its joint venture partner. Investigations revealed that Xerox costs were excessive due to gross inefficiencies in manufacturing processes and business practices. It lead Xerox to embark on a long term programme to benchmark its key work processes against best practices, persued by its competitors in Japan. Over the year Xerox extended benchmarking to almost every activity connected with its business.

Similar benchmarking strategy was adopted by Southwest Airlines to reduce the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit.

PROBLEMS IN MEASURING PERFORMANCE

The measurement of performance is a critical part of evaluation and control. The lack of quantifiable performance standards and the inability of the information systems to provide timely and valid information are two obvious control problems. Without objective and timely measurements, it is very difficult to make operational and strategic decisions. However, the use of timely, quantifiable standards does not guarantee good performance. The act of monitoring and measuring of performance can cause side effects which interfere with the overall performance of the organization. The most frequent negative side effects are short term orientation and goal displacement.

(i) Short-term Orientation: Senior executives find that in majority of situation they analyse neither long-term implications of present operations on the strategy they have adopted nor the operational impact of a strategy on the corporate mission. Executives are not conducting long-term evaluations due to the reasons that they believe that short-run considerations are more important than long-run considerations. They do not personally evaluate on long-term basis.

(ii) Goal Displacement: Goal displacement is the confusion of means with ends and occurs when activities originally intended to help managers attain corporate objectives become ends in themselves and are adapted to meet ends other than those for which they were intended. Goal displacement may be behaviour substitution and sub-optimisation. Behavior substitution refers to a phenomenon where people substitute activities that do not lead to goal accomplishment for activities which do lead to goal accomplishment since the wrong activities are being rewarded. Managers tend to concentrate their attention on those behaviors that are clearly measurable than those that are not measurable. Employees also do not receive appropriate reward for doing in hard-to-measure activities such as cooperation and initiative. However, easy to measure activity might have little or no relationship to the desired good performance. Rational people nevertheless tend to work for the rewards that the system has to offer. Therefore, people tend to substitute behaviors that are recognized and rewarded for those behaviour which are ignored, without regard to their contribution to goal accomplishment. The law

governing the effect of measurement on behaviour seems to be that the quantifiable measures drive out non-quantifiable measures.

Sub-optimisation refers to the situation when a unit optimizes its goal accomplishment to the detriment of the organization as a whole. The attention in large organizations on developing separate responsibility centers may create problem for the organization. When a division or a functional unit is viewed as a separate entity, it may refuse to cooperate with other units in the same organization if cooperation could in some way negatively affect its performance evaluation. One division's or unit's effort to optimize the accomplishment of its goals can cause other division to fall behind and hence negatively affect the overall performance of the organization. Further, competition between divisions to achieve higher return may result in one division's refusal to share its new technology or work process improvements.

STRATEGIC INCENTIVE MANAGEMENT

In order to ensure equivalence between the needs of the organization as a whole and the needs of employees as individuals, management and the Board of Directors should develop incentive programme which rewards desired performance. This reduces the likelihood of agency problems i.e., employees prefer to increase their incentives rather than building shareholders value. Incentive plans should be linked to corporate and divisional strategy. The following approaches are used by organizations to match measurements and rewards with explicit strategic objectives and timeframes.

(i) Weighted-factor method: This method is particularly suitable for measuring and rewarding the performance of top strategic business unit managers and group level executives when performance factors and their importance vary from one strategic business unit to another. An organization measurement may contain variations such as: (a) the performance of high-growth strategic business unit is measured in terms of market share, sales growth, designated future payoff and progress on several future-oriented strategic projects; (b) the performance of low-growth strategic business unit in contrast is measured in terms of return on investment and cash generation; and (c) the performance of medium-growth strategic business unit is measured for a combination of these factors.

(ii) Long-term evaluation method: This method compensates managers for achieving objectives set over a multiyear period. Providing incentives would be contingent on meeting the objectives of the companies' within the designated time. Any executive who leaves the company before meeting the objective will not receive any incentive.

(iii) Strategic-funds method: This method encourages managers to look at developmental expenses as being different from expenses required for current operations. It is to distinguish between expenses for current revenues and those invested in the future of the business. The manager has to be evaluated on both short and long-term basis and should be an incentive to invest strategic funds for the future.

An effective way to achieve the desired strategic results through a reward system is to combine the above three approaches.

The method which compensates managers for achieving objectives set over a multiyear period is called:

- (a) Weighted Factor method***
- (b) Long term evaluation method***
- (c) Strategic Funds method***
- (b) Long term evaluation method***



STRATEGIC AUDIT

Strategic audit refers to a checklist of questions, by area or issue which enables a systematic analysis of various corporate functions and activities to be made. This is a type of management audit and is useful as a diagnostic device to pin-point corporate wide problem areas and to highlight organizational strengths and weaknesses. It also helps to determine why certain areas create problems for a company and help to generate solutions to these problems. It is not an all-inclusive list, but it presents many of the critical questions needed for a detailed strategic analysis of any business organization. Some areas may be inappropriate for a particular company; but in some situations the questions may be insufficient for a complete analysis. However, each question in a particular area of the strategic audit can be broken down into an additional series of sub questions. The following are the common area in which a common strategic audit can be undertaken:

- (i) Evaluation of current performance
- (ii) Review of corporate governance
- (iii) Scan and assess the external and internal environment
- (iv) Analysis of strategic factors (SWOT)
- (v) Strategic alternatives
- (vi) Implementation of strategies
- (vii) Evaluation and control.

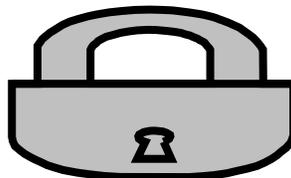
LESSON ROUND UP



- Performance measurement includes the objective and subjective assessments of the performance of both organization and sub-units of an organization such as divisions or departments.

- Performance evaluation is the process of attaching value of weights to various measures of performance to represent the importance of achievement on each dimension.
- Broadly, performance is measured with the help of financial indicators represented by different financial ratios. Popular ratios for measuring performance of an organization are earning per share, return on equity, and return on investments, etc.
- Now-a-days EVA, MVA and balanced score card are increasingly being used as performance measurement criteria. EVA is an estimate of true economic profit after making corrective adjustments to generally accepted accounting principles, including deducting the opportunity cost of equity capital. EVA can be measured as net operating profit after taxes less the money cost of capital. MVA is the difference between current market value of the firm and the capital contributed by the investors.
- The balanced scorecard is a tool used by the firm and its strategic planners to develop an appropriate balance between its strategic and financial controls. An effective balance between strategic and financial controls allows for the flexible use of core competencies, but within the parameters indicated by the firm's financial position.
- Performance evaluation of the management team is important from the perspective of strategic management. But it is the most challenging area in performance measurement. Generally we measure the performance of management by looking at parameters like stock price, length of tenure, strategy and goals followed by the management, insider buying and compensation of management.
- For measuring divisional performance different responsibility divisions like, cost centre, revenue centre, investment centre, profit centre and expense centre are used and then different financial or economic indicators are used to measure the performance of a particular divisional format.
- For measuring performance of different functional areas, certain key performance indicators are identified for each functional area and then the performance is measured for each of the indicator critical for the organization.

SELF TEST QUESTIONS



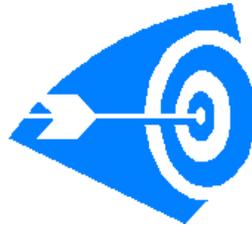
1. "Performance measurements include the objective and subjective assessments of the performance of organisation and sub-units". Discuss.
2. Explain the various primary measures of corporate performance.
3. Explain the concepts: (i) Market value Added (ii) Economic Value Added.
4. What is the difference between Market Value Added and Economic Value

Added?

5. What do you mean by balanced score card approach? Explain the different perspectives of balanced scorecard.
 6. Explain how do you evaluate the performance of top management?
 7. Discuss the different responsibility centres evolved for measuring divisional performance.
 8. List out the key performance indicators of manufacturing and production function.
 9. Explain the process of benchmarking of performance.
 10. What do you mean by strategic audit?
-

STUDY VI
RISK MANAGEMENT

LEARNING OBJECTIVES



The object of this study lesson is to enable the students to:

- Understand the meaning of risk and different types of risk and its impact on the business.
- Examine the cost of risk.
- Discuss the elements of risks.
- Understand the concept of risk management, its objectives, significance and benefits.
- Explain the applicability of risk management.
- Understand the risk management process.
- Explain the trade-off between risk and return.
- Monitor the techniques of risk analysis.
- Discuss the management of business risks in organizations.
- Understand the feasibility of enterprise risk management.
- Explain the responsibilities of management in implementing risk management.
- Examine the strategies in risk mitigation.

INTRODUCTION

Risk management has become a prime concern for every business in the present global competitive and knowledge based environment. Bankruptcies and huge losses have re-emphasized the importance of identifying and managing risks effectively.

Illustration:

Companies such as WorldCom, Enron, Lehman Brothers, etc., have all burnt their fingers in the global market due to faulty risk management practices. Even some a non-banking company had to pack their bags after suffering from huge losses due to risky ventures which were totally inconsistent with their resources and capability.

So the companies need to develop and apply an integrated risk management framework which can inspire the confidence of shareholders by stabilizing their earning and lowering the cost of capital.

Every business entity in the world exists to provide value for its stakeholders. All entities face uncertainty or risk and the challenge for management is to determine how much uncertainty or risk to accept as it strives to grow stockholder value. Uncertainty presents both risk and opportunity with potential to erode or enhance value. Risk management enables the organisation to effectively deal with uncertainty and associated risk and opportunity to build the value.

Business value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risk and efficiently and effectively deploys resources in pursuit of the entity's objectives.

Risk management helps management to achieve the entity's performance and profitability targets and prevent loss of resources. Risk management helps to ensure effective reporting and compliance with laws and regulations and helps to avoid damage to the entity's reputation and associated consequences. It also helps an entity to accomplish its target where it wants to go and avoid pitfalls and surprises along the way.

Risk is an exposure of uncertainty of outcome, whether positive opportunity or negative threat, of actions and events. It refers to the uncertainty that surrounds future events and outcomes. It is the expression of the likelihood and impact of an event with the potential to influence the achievement of an organization's objectives. The phrase "the expression of the likelihood and impact of an event" implies that, as a minimum requirement, some form of quantitative or qualitative analysis is required for making decisions concerning major risks or threats to the achievement of an organization's objectives. For each risk, two calculations are required:

- (i) Its likelihood or probability; and
- (ii) The extent of the impact or consequences.

Risk is used to describe any situation where there is uncertainty about what outcome will occur. Even the short term future is often highly uncertain. Risk is often used in a more specific sense to indicate possible variability in outcomes around some expected value and other times to describe the expected losses.

The term risk has been expressed in various forms as under:

- (i) The chance of loss,
- (ii) The probability of loss,
- (iii) Uncertainty,
- (iv) The dispersion of actual from expected result, and
- (v) The probability of any outcome different from the one expected.

Thus, risk is basically a condition in which there is a possibility of an adverse deviation from a desired outcome which is expected or hoped for.

Risk and Uncertainty

In simple words, risk may be defined as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations. The term uncertainty is often used in connection with the term risk, sometimes even interchangeably. Thus, it seems appropriate to explain the relationship between the terms risk and uncertainty.

Uncertainty is the lack of complete certainty, i.e., the existence of more than one

possibility. The true outcome/state/result/value is not known. In order to measure uncertainty, a set of probabilities is assigned to a set of possibilities. Say, there is a 70% chance that the share market index market will double in next two years".

Risk is a state of uncertainty where some of the possibilities involve a loss, catastrophe, or other undesirable outcome. The measurement of risk is a set of possibilities each with quantified probabilities and quantified losses. Example: there is a 50% chance that the proposed "oil well" will be dry with a loss of ₹10 crores in exploratory drilling costs.

In this sense, it is observed that one may have uncertainty without risk but not risk without uncertainty. We can be uncertain about the winner of a contest, but unless we have some personal stake in it, we have no risk. If we bet money on the outcome of the contest, then we have a risk. In both the cases, there are more than one outcome. The measure of uncertainty refers only to the probabilities assigned to outcomes, while the measure of risk requires both probabilities for outcomes and losses quantified for outcomes.



Risk is a concept which denotes a potential negative impact to some characteristics of value which may arise from a future event. In other words, risks are events or conditions that may occur, and whose occurrence, if it does take place, has a harmful or negative effect.

Exposure to the consequences of uncertainty constitutes a risk. Events can have negative impact, positive impact or both. Events with a negative impact represents risk which can prevent value creation or erode existing value. Events with positive impacts may offset negative impacts and represent opportunities. In everyday usage, risk is often used synonymously with the probability of a known loss.

Risk in itself is not bad; risk is essential to progress, and failure is often a key part of learning. But we must learn to balance the possible negative consequences of risk against the potential benefits and opportunity associated with it. It is neither possible nor desirable to completely eliminate the risk from a business. Focusing entirely on prevention of risks may result in elimination of returns as well. Instead, what is required is an understanding of all the risks which arise from a particular business and then managing these risks effectively. In an organization almost every decision has a higher and a lower side involving certain degree of risk.

Potential risk events can be associated with the following range of source categories:

- political;
- regulatory;
- customers;
- environmental;
- economic;
- commercial/strategic;
- financial;

- public health/safety;
- infrastructure planning/design;
- procurement/contractual;
- assessment of IPR;
- construction, operation and maintenance;
- asset failure;
- support service failure;
- security of assets, litigational;
- organisational; and
- natural events.

It is important to recognise that, while some events might appear to be caused by material or system failure, ultimately all risk events arise as a result of human nature or behaviour at some stage in the preceding chain of events, for example:

- human error;
- insufficient or limited knowledge;
- failure to properly manage knowledge;
- inadequate experience;
- wrong perception;
- changes in community perceptions as to the importance of particular issues; and
- uncertainty about the future.

Following are some of the examples of risks which are common to any organization:

- failure to recognise and take advantage of opportunities;
- failure of a project to reach its objectives;
- failure of physical infrastructure, equipment etc.;
- customer dissatisfaction;
- unfavourable publicity;
- a threat to physical safety;
- a breach of security;
- mismanagement;
- a breach of legal or contractual responsibility;
- fraud;
- financial crunch;
- political and regional agitation;
- failure in quality management;
- natural calamities;
- deficiencies in financial controls and reporting.

Risks always carry cost. The greater the risk, the greater will be the cost. The lower the risk; the lower will be the cost.

Illustration:

Suppose there are two identical houses in two different localities having the same value say rupees twenty lakhs each. There is no risk of damage to any of the house. Suddenly, the scientists announce that the tremor might hit the earth and one of the houses in the coming week because it is located in the potential impact area. In this situation we may say that one of the house has greater risk as compared to the other. Let us assume that the probability of one house being hit by the tremor is 0.1 whereas probability of being hit for other house is zero. In this situation the accepted property loss at one house is greater by ₹20,000 ($0.1 \times ₹2,00,000$). So if the owner of risky house wishes to sell his house immediately after announcement of the news, the potential buyer would naturally pay less than the actual price of the house. Thus, it makes it clear that greater risks in the sense of higher expected loss is costly proposition to the house owner. The value of the house will come down by the amount of expected loss. This is the case of direct loss due to risk. There may be indirect losses also.

Thus, the cost of risk consists of all related costs from the perspective of shareholder. The cost of risk may be presented in the following form:

$$\text{Cost of risk} = \text{Value without risk} - \text{Value with risk.}$$

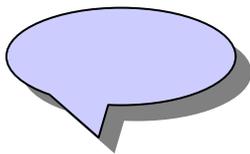
Further, stating the expression in terms of organizations' value to shareholders in the presence of risks is as under:

$$\text{Value with risk} = \text{Value without risk} - \text{Cost of risk.}$$

It may be noted that as long as the costs are defined to include all the effects on value of risk and risk management, minimizing the cost of risk is same thing as maximizing the value.

COMPONENTS OF COST OF RISK

Cost of risk has multiple components. The important components includes the following:



- (a) *expected losses*
- (b) *cost of loss control*
- (c) *cost of loss financing*
- (d) *cost of internal risk reduction*
- (e) *cost of any residual uncertainty*

(a) *Expected Losses*: It basically includes the expected cost of both direct and

indirect losses. Under the direct cost, one may include the cost of repairing or cost of replacing the damaged assets or property, compensation claimed by injured persons, cost of defending legal claims etc. As against direct losses, indirect losses cover reduction in net profits which may result as a consequence of direct loss. Indirect losses also include loss of profit from investment forgone and in the event of situation of bankruptcy, legal expenses as well as cost associated with the re-organization and liquidation of a business.

(b) Cost of loss control: The cost of loss control basically covers the increased cost of organization on account of precautions and limits on risky activity designed to reduce the frequency of mishappening and accidents.

(c) Cost of loss financing: It consists of cost of self insurance, the transaction cost in arranging, negotiating, enforcement of hedging arrangements and other contractual risk transfers and payment of insurance premium. The cost of self insurance covers cost of maintaining reserve funds to pay losses.

(d) Cost of internal risk reduction: It includes the transaction cost associated with achieving diversification and the cost associated with managing a diversified set of activities such as cost of obtaining and analyzing data and other types of information to obtain more accurate, precise cost for forecast.

(e) Cost of any residual uncertainty: Practically the uncertainty and the magnitude of the losses may not be completely eliminated by using various means such as loss control insurance, hedging, other contractual risk transfer and through internal risk exercise. So the cost of uncertainty which is left over is known as cost of residual uncertainty. The residual uncertainty may result in reducing the value through its effect on net cash flows. It may reduce the price which customers are willing to pay for the organizations products or cause executives or employees to demand higher pay packages.

TYPES OF RISKS

Risks may be broadly classified under the following types:

(1) Systematic Risk: It refers to risk which affects the entire market. This type of risk is not diversifiable and can not be eliminated. A significant political event, for example, could affect several of the assets in your portfolio. Interest rates, recession, political disturbances, change in government policy etc., all represent sources of systematic risk because they affect the entire market and cannot be avoided through diversification. Systematic risk can be mitigated only by hedging exercise. Even a portfolio of well-diversified assets cannot escape all risk. It is virtually impossible to protect anybody against this type of risk.

(2) Unsystematic Risk: It is also known as diversifiable risk or residual risk or specific risk. This kind of risk affects a very small number of assets such as news that affects a specific share or due to sudden strike by employees. This risk can be eliminated

(3) Market Risk: The market risk is also called the undiversifying risk, because this risk can not be avoided no matter how many different stocks might be present in the portfolio. This is the most familiar of all risks. Market risk is the day-to-day

fluctuation in a stock's price. It applies mainly to stocks and options. As a whole, stocks tend to perform well during a bull market and poorly during a bear market. Volatility is not so much a cause but an effect of certain market forces.

Thus, the market risk is the risk where the value of an investment will increase/decrease due to changes in market factors. The market risk is generally uncontrollable i.e. beyond the control of the organization.

Some of important factors which are associated with the market risk are as discussed below:

- (i) *Equity Risk*: It is the risk which changes the share prices.
- (ii) *Interest Rate Risk*: It is the risk which changes the interest rates.
- (iii) *Currency Risk*: It is the risk which changes the foreign exchange rates.
- (iv) *Commodity Risk*: It is the risk which changes the commodity prices (e.g. grains, metals).
- (v) *Credit (Finance) Risk*: It is the risk which changes the credit prices/spreads.

(4) Business Risk: It basically refers to the situation of uncertainty associated with operating cash flows of a business. Business risk can be divided into external and internal risk. External business risk is the result of operating conditions which are imposed upon the organisation by circumstances beyond its control. Each organisation faces its own set of external risks, depending upon the specific operating environmental factors. Internal business risk is associated with the efficiency with which a firm conducts its operations within the broader operating internal environment imposed upon it. Each firm has its own set of internal risks, and the degree to which it is successful in coping with them is reflected in their operating efficiency. The major business risks which give rise to variation in cash flows and business value are price risk, credit risk and pure risk.

- (a) *Price Risk*: It refers to the situation where there is uncertainty over the magnitude of cash flows in the organization due to possible changes in the prices of output and input. Price risks may be of different form such as commodity price risk and exchange rate risk. Commodity price risk generally occurs on account of fluctuations in the prices of commodities such as price of wheat, oil, electricity which are inputs for one firm and output for other firm. In this era of global competition and knowledge revolution, output and input prices of various products for many firms are also influenced by fluctuations in exchange rates.
- (b) *Credit Risk*: It is concerned with commercial operations of the organization such as creditworthiness risks; risks in settlement of dues by clients; provisions for doubtful and bad debts. Credit risk is thus, the risk of loss due to a debtor's non-payment of a loan or other line of credit. The exposure to credit risk is a common phenomenon for financial institutions such as commercial banks which are in the business of lending loans subject to risk of defaulter by the borrower. It is often related to default risk. It is the chance under which the person or institution you are lending to is unable to repay the debt. Technically, credit risk is the chance that the company selling

bonds is unable to make debt payments. As a result, the company may default on its debt or have to file for liquidation or bankruptcy.

- (c) *Pure Risk*: It basically covers risk of reduction in value of business assets as a result of physical damage, theft, risk of legal liability for damages or harms to customers, supplier shareholders etc., risk associated with the payment of benefits to injured workers as per compensation law, risk of death, illness and disability to employees which results in payments to employees under various statutes and benefit plans of the organization.

(5) Purchasing Power Risk: Purchasing-power risk is another type of risk where there is the uncertainty of the purchasing power of the amounts to be received. In simple terms, purchasing power risk refers to the impact of inflation or deflation in the economy on an investment. The rising prices on goods and reserves are normally associated with what is referred to as inflation. Conversely falling prices on goods and services are covered under deflation.

(6) Interest-Rate Risk: It is the risk where an investment's value will change as a result of a change in interest rates. To be more precise it is the exposure to adverse movements in interest rates. This risk influences the value of bonds more directly than stocks. In other words, it is the chance that interest rates will change while you hold an investment. Higher rates of interest results in lower returns on stocks and bonds. Interest rate basically changes the real value of investment upward/downward.

(7) Financial Risk: Financial risk is the uncertainty associated with how an organization finances its business (i.e., debt equity). It is associated with the way in which a company mobilizes resources to finance its activities. The presence of borrowed capital in the capital structure creates fixed charge in the form of interest sustained by the organisation. The interest commitments and payment of preference dividend cause the amount of residual earning available for distribution to the equity shareholders. Financial risk is avoidable risk to the extent that management has the freedom to make a choice, the combination of debt and equity in the financial structure. An organization with no debt financing has no financial risk.

(8) Default Risk: It is the risk under which a company or individual is unable to pay the contractual interest or principal on its debt obligations. This type of risk is of particular concern to investors who hold bonds in their portfolios. In other words, it is the uncertainty which is associated with the payment of required cash flows of a security (i.e., the interest or principal of a bond) when promised or due.

(9) Investment Risk: It is the chance with which your investment value will fall. Standard deviation is commonly used to measure the investment risk. It shows a share or bond's volatility or the tendency of its price to move up and down from its average. As standard deviation increases, so does investment risk.

(10) Inflation Risk: Bonds are especially vulnerable to inflation risk. This is because a bond's coupon payment is usually a fixed amount. When there is inflation, the present value of the coupon falls. Equity shares have less risk of this nature since dividends can be adjusted for inflation.

(11) Operational Risk: These risks are broadly associated to the company's

organisation and management such as planning, monitoring and reporting systems in the day to day management process such as risks to property; clear as well as defined work processes; changes in technology/upgradation; research and development risks; agency network risks; environmental and pollution control regulations, etc.; locational benefits near metros, railway stations, ports, cities, etc.

Important forms of operational risks are discussed as follows:

- (a) *Process Risks*: These risks stem from the design of the process and the extent of manual or human element in the process. A common risk is capturing incorrect data. Since data capture is often the very first step in a process exercise an error may lead to undesirable consequences in all the succeeding steps and rectifying the error in turn involves many stages of rollback.
- (b) *People Risks*: This risk is rarely considered a formal risk. A manager in an organization is probably aware that there is excessive dependence on one person, but this also means that he is too busy to train someone else. A formal identification of key persons and a strategy to contain that risk is essential. Likewise, formal process of documentation, recruitment, induction, ongoing training and motivation policies are very important to mitigate those human resource risks.
- (c) *Technology Risks*: Technology becomes a key element of the business process and its maintenance and performance becomes a key risk factor. The risks associated with the hardware side of technology are somewhat easier to contain, because they involve simple monetary costs in redundancies. Hardware and networking skills are somewhat at a premium, but these are generic skills and can be had at a cost. The risk associated with the application side is far more dangerous and difficult to manage. Application of technology is invariably customized to the needs of particular business.

(12) Industry and Services Risks: These types of risks can be broadly categorized as follows, namely:

- Economic risks such as dependence on one product, one process, one client, one industry, etc., in the short and long term
- Market structure
- Business dynamics
- Competition risks affecting tariffs prices, costs, revenues and customer preferences
- Customer relations risks, etc.

(13) Political Risks: These risks are related to political uncertainties such as:

- Elections
- War risks
- Country/Area risks

- Insurance risks like fire, strikes, riots and civil commotion, marine risks, cargo risks, etc.
- Fiscal/Monetary Policy Risks including taxation risks, etc.

(14) Systems Risks: These risks which are related to the company's systems such as:

- System capacities
- System reliability
- Obsolescence risks
- Data Integrity risks
- Coordinating and interface risks.

(15) Legal Risks: Legal risk covers the risks relating to the activities of legal nature such as:

- Contract risks
- Contractual liability
- Frauds
- Judicial risks
- Insurance risks.

(16) Disaster Risks: These risks relate to disasters. Disaster is result of various factors such as:

- Natural risks like fires, floods, earthquakes, etc.
- Man-made risks, factors arising under the Factories Act, Mines Act, etc.
- Risk of failure of effective disaster management plans formulated by the company.

ELEMENTS OF RISK IN BUSINESS

The risk elements can also be classified as under and referred to as the 10 Ps.:

Each element represents its own type of risks that interact with, and impact on, the others sometimes positively and sometimes negatively.

(1) Premises: It covers the multiple variables such as:

- location of the organization
- type of premises available for use
- amenities, distribution routes and access for customers.

(2) Product: It includes the variables such as:

- industry sector
- features of product or service offered
- life cycle and fashion trends
- materials used in production
- green issues and quality.

- (3) Purchasing:** It covers:
 - access to supplies
 - storage and warehouse facilities
 - stock control, payment terms and cost.
- (4) People:** It consists of:
 - workers in the organization
 - skills, training needs, motivation and commitment
 - incentive packages available and employment contracts.
- (5) Procedure:** It includes:
 - production procedures
 - record keeping and reporting systems
 - monitoring and review, use of standards and emergency procedures.
- (6) Protection:** It consists of:
 - personal protection of workers and others
 - property and vehicle security
 - insurance cover
 - information systems and data security.
- (7) Processes:** It consists of:
 - production processes
 - waste and scrap disposal
 - skills, technology and new materials.
- (8) Performance:** It consists of:
 - target sets, monitoring, measurement tools
 - consistency and validity of data.
- (9) Planning:** It consists of:
 - access to relevant data
 - management skills
 - external factors and levels of control
 - short and long-term planning and investment options.
- (10) Policy:** It consists of:
 - range of policies that support the strategic plans of the firm.

It is very difficult to eliminate all the risks in all the areas. It is also risky and complicated exercise to set-up, operate and develop a successful business. With efficient and professional management system, it is possible to alleviate or spread the risk, in such a way that it retains the excitement and challenge of running a successful business while protecting the interest of all stakeholders from potential loss. An evaluation of all the business operations requires honesty and motivation in

order to produce a comprehensive, detailed analysis of potential risks within all the areas listed above. Each of these ten areas of business management for the risk factors, provide the tools for assessing the risks they represent in order to prioritize subsequent risk reduction activities.

CONCEPT OF RISK MANAGEMENT

Risk management has its origins from the field of corporate insurance. Presently it is recognized as a distinct and important function of all businesses organizations. Although the term risk management is a recent phenomenon, yet the actual practice of risk management is as old as civilization itself.



Risk management refers to identification of opportunities and avoiding or mitigating losses. It is a logical and systematic process of establishing the context, identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process, in a way which enables an organisation to minimise losses and maximise opportunities.

Risk management is also considered as a structured approach in managing uncertainty related to a threat, a sequence of human activities including: risk assessment, strategies development to manage it, and mitigation of risk using managerial resources. The strategies include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk. Hence, risk management is a scientific approach to deal with pure risks by anticipating possible accidental losses and designing and implementing procedures which minimize the occurrence of loss or the financial impact of the losses that do occur.

Risk management is also an integral component of good management and decision-making at all levels. All departments manage risk continuously whether they realize it or not, sometimes more rigorously and systematically and sometimes less so. More rigorous risk management occurs most visibly in departments whose core mandate is to protect the environment and public health and safety. Such a risk management process is essentially a part and parcel of the operations and management functions in the business unit. It means that each department and the executives therein are directly or indirectly involved in the risk management function. The effectiveness of the risk management of the industry or business unit, therefore, depends on the efficiency with which the managers/executives of different departments handle it as part of their roles.

Thus, risk management is the process for dealing with uncertainty within a public policy environment. To be precise, risk management is a systematic approach for setting the best course of action under uncertainty by identifying, assessing, understanding, acting on and communicating risk issues.

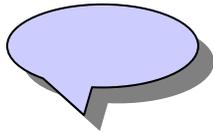
The major characteristics of risk management are as under:

- (i) It is a systematic discipline for dealing with problem of uncertainty
- (ii) It provides a system of making choices
- (iii) It is a way for better understanding of potential liability

(iv) It is a guide for responding to undesirable events.

The guiding principle or fundamental objectives of risk management is to minimize the cost of risk. When we consider the business risk management's decisions, the objective is to minimize the firm's cost of risk. In case of individual risk management the objective is to minimize firm's cost of risk. As against above, the objective of risk management decision in case of public policy is to minimize society's cost of risk.

Broadly speaking, the objectives of risk management is:



- *To provide a structured framework for more effective strategic planning*
- *To ensure maximising of opportunities and minimisation of losses*
- *To widen management perspective and encourage initiative and pro-active behaviour*
- *To contribute to improved organisational efficiency and effectiveness*
- *To optimise the use of resources*
- *To promote greater openness in decision-making and improve communication*
- *To provide senior management with a concise summary of the major risks affecting the organisation and a mechanism to ensure that appropriate resources are directed towards areas of high risk*
- *To provide a framework for ensuring that unavoidable risks are adequately insured*
- *To provide an effective and systematic approach which enables management to focus on areas of risk in their operations*
- *To improve the level of accountability in the organisation*
- *To identify and prioritise potential risk events*
- *To help in developing risk management strategies and risk management plans*
- *To analyse and report identified risk events*
- *To find ways to identify and evaluate risks*
- *To develop strategies and plans for risk management strategies.*

Thus the objective of risk management is to reduce different risks related to a pre-selected domain to the level accepted by society. Effective risk management can bring far-reaching benefits to all organizations, whether large and small, public or private sector. Effective risk management structure supports better decision-making through a good understanding of risks and their likely impact. Risk management also reduces the dreadful impact of risks on the various organizations also in the internal workings of many corporate and semi-corporate sectors. The persons or the organization entrusted with the task of risk management aim at lessening the risk

faced by a person, a group of persons or an organization covering a wide range of areas.

SIGNIFICANCE OF RISK MANAGEMENT

In order to apply risk management effectively, it is vital that a risk management culture be developed. The risk management culture supports the overall vision, mission and objectives of an organization. Limits and boundaries are established and communicated concerning what are these acceptable risk practices and outcomes.

Since risk management is directed at uncertainty related to future events and outcomes, it is implied that all planning exercises encompass some form of risk management. There is also a clear implication that risk management is everyone's business, since people at all levels can provide some insight into the nature, likelihood and impacts of risk.

The traditional role of the risk manager as corporate steward is evolving as organizations face an increasingly complex and competitive business environment. Do you agree? Discuss briefly?

Yes, I agree with the statement, as today the risk manager is a key member of the senior executive team in an organisation who helps to define business opportunities from a risk-return perspective, presents unique ways of looking at them, has direct input into the configuration of products and services, and ensures the transparency of all the risks. Innovation necessitates new yardsticks for measuring and monitoring the resulting activities.



Risk management is no longer discretionary but essential for managing business entities in this dynamic corporate world environment. It takes commitment from the top, a sound methodology and discipline in its application to obtain the maximum benefit. In short, risk management must become imbibed into the organization's culture.

All companies have express or implied objectives which ultimately contribute to the maximization of shareholders value. Risk management actively supports the achievement of those objectives. It is not a process for avoiding risk. Properly implemented risk management can actively allow a company to undertake activities which have a higher level of risk thereby achieving a greater benefit because risks have been identified, understood and well managed. Organizations which have risk management policies in place shall be rewarded by added premium in the market and shall be better placed to pursue objectives and opportunities with confidence.

Risk management can be seen as a tool for creating opportunities for the businesses as they develop during the risk management process. Moreover such opportunities that arise also from the complementary effect of risk management with other business planning process. It is pertinent to note that every activity carries a potential reward as well. Risk management, essentially, is about managing risk against reward.

In other words, risk management is not just about preventing risks, but also managing it properly. However, managing risks properly does not mean becoming risk averse, or ignoring new opportunities for being too risky. It simply provides a framework to:

- Help in ensuring that all the foreseeable risks involved are actually understood and accepted before important decisions are taken.
- Monitor new projects, and ongoing operations, to ensure that they would continue to develop satisfactorily, and no problems or new risks emerge.

Properly implemented risk management has many potential advantages to an organization in the form of:

- Better informed decision making in assessing new opportunities;
- Less chance of major problems in new and ongoing activities; and
- Increased likelihood of achieving corporate objectives.

BENEFITS OF RISK MANAGEMENT

A certain amount of risk taking is inevitable if an organization is to achieve its objectives. The organizations that are aware of risks appreciate that actively by managing threats and opportunities to provide them with a competitive advantage. Taking and managing risk is the very essence of business survival and growth. Risk management provides a clear and structured approach in identifying risks. Having a clear understanding of all the risks allows an organization to measure and prioritize them and take appropriate actions to reduce losses. Risk management has the following benefits for an organization:

The benefits of implementing risk management are as follows:

1. A risk-based approach can make a company more flexible and responsive to market fluctuations making it better able to satisfy customers' ever-changing needs in a continually evolving business environment.
2. Companies can gain an early-mover advantage by adapting to new circumstances faster than their rivals, which again could lead to competitive advantage in the long-run.
3. External perceptions of a company are affected by the level of risk that it faces and by the way its risks are managed.
4. Companies need to be aware of changing markets, service delivery and morale.
5. Effective risk management and internal control can be used to manage change, to all levels of people in the company in meeting its business objectives, and to improve a company's credit rating and ability to raise funds in the future, not to mention its share price over the longer term.
6. It saves resources — time, assets, income, property and people are all valuable resources.
7. Risk management protects the reputation and public image of the organization.
8. It prevents or reduces legal liability and increases the stability of operations.

SCOPE AND APPLICABILITY OF RISK MANAGEMENT

Risk management should be most rigorously applied where critical decisions are being made. Decisions about risk will vary depending on whether the risk relates to long, medium or short term goals.

Broadly speaking the major aspects which are covered in the scope of risk management include the following:

1. *Strategic Decisions:* Strategic decisions are primarily concerned with long-term goals which set the context for decisions at other levels of the organization. The risks associated with strategic decisions may not become apparent until put in proper perspective with reference to future. Thus, it is essential to review these decisions and associated risks on a regular basis.
2. *Program and Project Level:* Medium-term goals are usually addressed through programs and projects to bring about business change. Decisions relating to medium-term goals are narrower in scope than strategic ones, particularly in terms of time frame and financial responsibilities.
3. *Operational level:* The emphasis is on short-term goals to ensure ongoing continuity of business services. However, the decisions about risk at this level must also support the achievement of long and medium term goals.

Risk management should also be applied during decision-making when planning the introduction of change at any of the organizational perspectives. In ideal risk management situation, a prioritization process is followed whereby the risks with the greatest loss and the greatest probability of its occurring are handled first and the risks with lower probability of occurrence and lower loss are handled in descending order. In practice, the process can be very difficult and balancing between risks with a high probability of occurrence but lower loss and a risk with high loss but lower probability of occurrence can often be mishandled.

Intangible risk management identifies a new type of risk - a risk which has a 100% probability of occurring but is ignored by the organization due to a lack of identification ability. For example, when deficient knowledge is applied to a situation, a knowledge risk materialises. Relationship risk appears when ineffective collaboration occurs. Process-engagement risk may be an issue when ineffective operational procedures are applied. These risks directly reduce the productivity of knowledge workers, decrease cost effectiveness, profitability, service, quality, reputation, brand value, and earnings quality. Intangible risk management allows or enables to create immediate value from the identification and reduction of risks that reduce productivity.

Risk management also faces difficulties in allocating resources. This is the idea of opportunity cost. Resources which are spent on risk management could have been spent on more profitable activities by the organisation. Again, ideal risk management minimizes the spending while maximizing the reduction of the negative

effects of risks. The resources which are available for managing risk are finite and so the aim of the organization is to achieve an optimum response to risk, prioritized in accordance with an evaluation of the risks.

Risk is unavoidable, and every organization needs to take action to manage risk in a way which it can justify to a level which is tolerable. The management of risk at strategic, program and operational levels needs to be integrated so that the levels of activity support each other. In this way, the risk management strategy of the organization will be led from the top and embedded in the normal routines and activities of the organization. All staff should be aware of the relevance of risk to the achievement of their objectives and training to support staff in risk management.

Managers at each level therefore need to be equipped with appropriate skills which will allow them to manage risk effectively and the organization as a whole needs a means of being assured that risk management is being implemented in an appropriate way at each level. Every organization should have a risk management strategy, designed to achieve the principles set out. The application of that strategy should be embedded into the organization's business systems, including strategy and policy setting processes, to ensure that risk management is an intrinsic part of the way business is conducted.

An effective risk management practice does not eliminate risks. However, having an effective and operational risk management practice shows that the organization is committed to loss reduction or prevention. Effective risk management helps to improve performance objectives by contributing to:

1. Better service
2. Reduction in management time
3. Increased likelihood of change initiatives being achieved
4. More focus internally on doing the right things properly
5. Better basis for strategy setting
6. Achievement of competitive advantage
7. More efficient use of resources
8. Reduced waste and fraud, and better value for money
9. Improved innovation
10. Better management of contingent and maintenance activities.

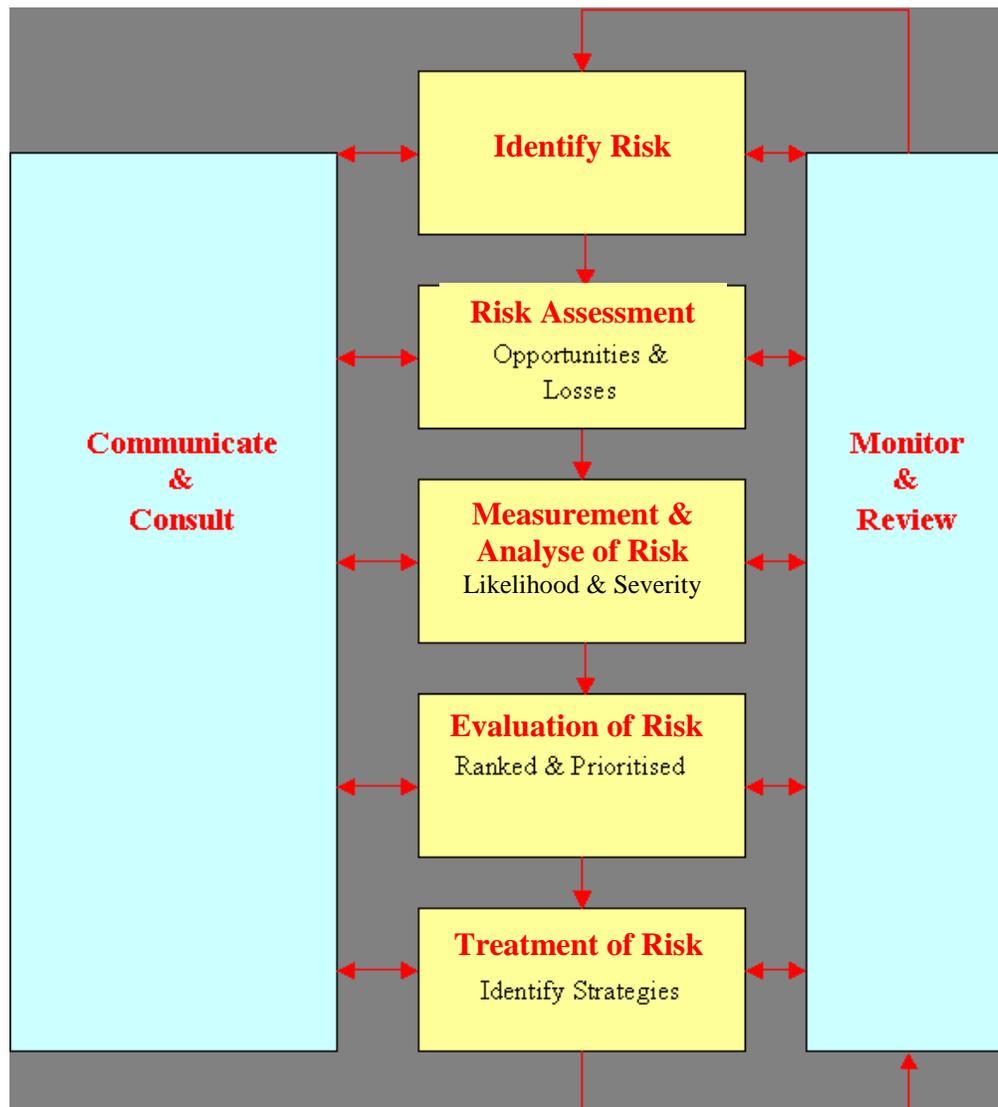
Many of these benefits are applicable to both the private and public sectors. Whereas private sectors focus mainly on shareholder returns and the preservation of shareholder value, the public sectors role is to implement programs cost-effectively, in accordance with government legislation and policies to achieve value for money.

RISK MANAGEMENT PROCESS

Management of risks starts with identification of risk and its quantification. It consists of a series of individual steps that must be accomplished in managing risks.

The process of risk management broadly consists of the following steps:

1. Risk identification
2. Risk assessment
3. Risk measurement and analysis
4. Risk evaluation
5. Risk treatment
6. Risk monitoring and review.



Risk Management Process

(1) Risk Identification

Risk cannot be managed unless it is first identified. Once the context of the business has been defined, the next step is to utilize the information to identify as many risks as possible. The aim of risk identification step is to identify possible risks which may affect, either negatively or positively, the objectives of the business and the activity under analysis.

The first step is to generate a comprehensive list of sources of threats, risks and events which might have an impact on the achievement of each of the objectives as identified at the time of preset ideas and past events. These events might prevent, degrade, delay or enhance the achievement of those objectives.

This is the phase where threats, vulnerabilities and the associated risks are identified. This process has to be systematic and comprehensive enough to ensure that no risk is unwittingly excluded. It is very important that during this stage all risks are identified and recorded, regardless of the fact that some of them may already be known and controlled by the organization.

In general, a risk may relate to or be characterized by –

- (i) It's origin: (e.g. threat agents like hostile employees or employees not properly trained, competitors, governments, etc.).
- (ii) A certain activity, event or incident (i.e. threat): (e.g. unauthorized dissemination of confidential data, competitor deploys a new marketing policy, new or revised data protection regulations, an extensive power failure).
- (iii) Its consequences, results or impact: (e.g. service unavailability, loss or increase of market/profits, increase in regulation, increase or decrease in competitiveness, penalties, etc.).
- (iv) A specific reason for its occurrence: (e.g. system design error, human intervention, prediction or failure to predict competitor activity).
- (v) Protective mechanisms and controls together with their possible lack of effectiveness (e.g. access control and detection systems, policies, security training, market research and surveillance of market).
- (vi) Time and place of occurrence (e.g. during extreme environmental conditions there is a flood in the computer room).

Risk management in an organization requires following information for identification of risks—

- (i) Asset information such as list of assets, its original cost, book value, replacement value etc.,
- (ii) Process information regarding raw materials, process and nature of plant, etc.,
- (iii) Product information whether consumer products or industrial product, chances of liability etc.,
- (iv) Liability information such as liability to its employees and liability to public.

Identifying what may happen is rarely sufficient. The fact that there are many ways in which an event can occur makes it important to study all possible and significant causes and scenarios. Some of the important methods and tools used to identify risks and their occurrence include checklists, judgments based on experience and records, flow charts, brainstorming, systems analysis, scenario analysis and systems engineering techniques.

In selecting a risk identification methodology, the following techniques may be considered:

- (i) Team-based brainstorming where workshops can prove effective in building commitment and making use of different experiences;
- (ii) Structured techniques such as flow charting, system design review, systems analysis, hazard and operability studies, and operational modeling;
- (iii) For less clearly defined situations, such as the identification of strategic risks, processes with a more general structure such as 'what-if' and scenario analysis could be used.

The following guidelines may be involved for effective risk identification:

- (a) Select a risk identification methodology appropriate to the type of risk and the nature of the activity.
- (b) Involve the right people in risk identification activities.
- (c) Take a life cycle approach to risk identification and determine how risks change and evolve throughout this cycle.

(2) Risk Assessment

Having identified all potential risks, it is time to assess or estimate the risks. Risk assessment is the reduction of measurement uncertainty by determining the magnitude of the risk. In precise terms, risk assessment is an attempt "to estimate the chance or probability of potential loss as well as the magnitude of the identified risk". Risk probability is categorized as being greater than zero and less than one hundred. On the other hand, consequence is determined relative to cost, schedule and technical goals. If the probability is one, the event is certain to occur. Calculating the probability of occurrence of risk means ascertaining the likelihood of actual happening of the risk. Probability data can be used to compute the risk. In the absence of any probability data, estimates by experts most familiar with the project, its risk factors and overall problems are a good substitute. Risk assessment may be done in two ways—either by qualitative or quantitative risk analysis. The qualitative data involves subjective units such as "high", "low", or "critical". The quantitative data uses numerical units such as "workdays" or "monetary units". The qualitative approaches are subjective assessments based on experience and intuition. The quantitative approaches however, are based on mathematical and statistical techniques which are objective in nature.

(3) Risk Measurement and Analysis

The next important step is the proper measurement of the losses associated with the risky exposure of the firm. This measurement includes a determination of:

- (a) The probability or chance of the losses that will occur,

- (b) The impact of the losses upon the financial affairs of the firm, and
- (c) The ability to predict the losses during the financial period.

The risk analysis thus assists in determining which risks have a greater consequence or impact than others. This helps to provide a better understanding of the possible impact of risk, or the likelihood of its occurring, in order to make a decision about committing resources to control the risk.

Risk analysis is the phase where the level of the risk and its nature are assessed and understood. This information is the first input to decision makers on whether risks need to be treated or not and what is the most appropriate and cost-effective risk treatment methodology.

The important elements of risk analysis include the following:

- (i) Intensive examination of the risk sources.
- (ii) Identification of existing strategies and controls that act to minimise negative risk and enhance opportunities.
- (iii) Determine the consequences of a negative impact or an opportunity.
- (iv) Determine the likelihood of a negative consequence or an opportunity that may occur and the factors that affect them.
- (v) Estimate the level of risk by combining consequence and likelihood.
- (vi) Consider and identify any uncertainties in the estimates.

This process is important because it indicates the exposures that are serious and consequently need urgent attention.

Risk management provides a centralized risk framework to document and manage all risks faced by an organization. It supports risk assessment and computations based on configurable methodologies and algorithms giving a clear view into organizations risk profile and enabling manager to prioritize their response strategies for optimal risk/reward outcomes.

The level of risk can be estimated by using various statistical analysis and calculations combining impact and likelihood. Any formulas and methods for combining them must be consistent with the criteria defined when establishing the risk management context. This is because an event may have multiple consequences and affect different objectives. Therefore consequences and likelihood needs to be combined to calculate the level of risk. If no reliable or statistically reliable and relevant past data or information is available (kept for an incident database), other estimates may be made as long as they are appropriately communicated and approved by the decision makers.

Information used to estimate impact and likelihood usually comes from the following:

- (i) Past experience or data and records (e.g. incident reporting),
- (ii) Reliable practices, international standards or guidelines,
- (iii) Market research and analysis,

- (iv) Experiments and prototypes,
- (v) Economic, engineering or other models,
- (vi) Specialist and expert advice.

The risk analysis techniques include: interviews with experts in the area of interest and questionnaires, and use of existing models and simulations. Risk analysis may vary in detail according to the risk, the purpose of the analysis, and the required protection level of the relevant information, data and resources. Analysis may be qualitative, semi-quantitative or quantitative or a combination of these. In any case, the type of analysis performed should be consistent with the criteria developed as part of the definition of the risk management context.

A short description of the above-mentioned analysis techniques is given as under:

(i) Qualitative Analysis

Under qualitative analysis, the magnitude and likelihood of potential consequences are presented and described in detail. The scales used can be formed or adjusted to suit the circumstances, and different descriptions may be used for different risks.

Qualitative analysis may be used:

- (i) As an initial assessment to identify risks which will be the subject of further detailed analysis;
- (ii) Where non-tangible aspects of risk are to be considered (e.g. reputation, culture, image etc.);
- (iii) Where there is a lack of adequate information and numerical data or resources necessary for a statistically acceptable quantitative approach.

(ii) Semi-quantitative Analysis

In semi-quantitative analysis the basic objective is to assign some values to the scales used in the qualitative assessment. These values are usually indicative and not real, which is the prerequisite of the quantitative approach. Therefore, as the value allocated to each scale is not an accurate representation of the actual magnitude of impact or likelihood, the numbers used must only be combined using a formula that recognizes the limitations or assumptions made in the description of the scales used.

It may be mentioned here that the use of semi-quantitative analysis may lead to various inconsistencies due to the fact that the numbers chosen may not properly reflect analogies between risks, particularly when either consequences or likelihood are extreme.

(iii) Quantitative Analysis

Under the quantitative analysis, numerical values are assigned to both impact and likelihood. These values are derived from a variety of sources. The quality of the entire analysis depends on the accuracy of the assigned values and the validity of the statistical models used. The impact thus can be determined by evaluating and

processing the various results of an event or by extrapolation from experimental studies or past data. The consequences may be expressed in various terms of:

- monetary
- technical
- operational
- human
- impact criteria

Risk needs to be basically quantified in two dimensions. The impact of the risk needs to be assessed. The probability of the risk occurring needs to be assessed. For simplicity, rate each on a 1 to 4 scale. The larger the number, the larger the impact or probability. By using a matrix, a priority can be established.

Probability	4	Medium	Critical		
	3				
	2	Low	High		
	1				
		1	2	3	4
		Impact			

It may be noted that if probability is high, and impact is low, it is a medium risk. On the other hand, if impact is high, and probability low, it is high priority. A remote chance of a catastrophe warrants more attention than a high chance of a setback.

The following can be considered as the guidelines for effective risk analysis:

- (a) Risk analysis is usually done in the context of existing controls, take the time to identify them.
- (b) The risk analysis methodology selected should wherever possible be comparable to the significance and complexity of the risk being analysed, i.e. the higher the potential consequence, the more rigorous the methodology.
- (c) Risk analysis tools are designed to help rank or prioritise risks. To do this they must be designed for the specific context and the risk dimension under analysis.

As it is made clear from the above analysis, the specification of the risk level is not unique. Impact and likelihood may be expressed or combined differently, according to the type of risk and the scope and objective of the risk management process.

(4) Risk Evaluation

Risk evaluation implies ranking in terms of importance, and ranking suggests measuring some aspect of the factors to be ranked. Risk evaluation involves

comparing the level of risk found during the analysis process with previously established risk criteria, and deciding whether these risks require treatment.

The result of a risk evaluation is a prioritized list of risks which require further action. In the case of loss exposure, the following two components should be considered:

- (a) The potential severity of loss.
- (b) The potential probability of loss.



Risk Evaluation requires input from several stakeholders including senior management particularly for the purpose of proactive reduction of risk (i.e. taking risk management action before a profit commences). The following three steps are taken in risk evaluation:

- *Establishment of acceptable level of risk depending on firm's propensity to take risk;*
- *Understanding how the various risks interact so as to group the risk responses according to their intended effect on the intended risk;*
- *Actions to be taken in relation to the risks in the form of risk mitigation, risk avoidance, risk acceptance or risk transfer.*

(5) Risk Treatment

Risk treatment is basically concerned with identifying options for treating or controlling risk, in order to either reduce or eliminate negative consequences, or to reduce the likelihood of an adverse occurrence. Risk treatment should also aim to enhance positive outcomes. It is often either not possible or cost-effective to implement all treatment strategies.

A business owner should aim to choose, prioritize and implement the most appropriate combination of risk treatments.

Treatment of risk is prioritised to:

- (a) Avoid the risk;
- (b) Change the likelihood of the occurrence;
- (c) Change the consequences;
- (d) Share the risk; and
- (e) Retain the risk.

A risk treatment plan indicates the chosen strategy for treatment of an identified risk. It provides the valuable information about the risk identified, the level of risk, the planned strategy, the time frame for implementing the strategy, resources required and individuals responsible for ensuring the strategy.

Risk treatments in the organisation may be implemented as under:

- (a) The key to managing risk is in implementing effective treatment options.
- (b) When implementing the risk treatment plan, ensure that adequate resources are available, and define a timeframe, responsibilities and a method for monitoring progress against the plan have been taken care of.
- (c) Physically check that the treatment implemented reduces the residual risk level.
- (d) In order of priority, undertake remedial measures to reduce the risk.

(6) Risk Monitoring and Review

Risk monitor and review is an essential and integral step in the risk management process. A business owner must monitor risks and review the effectiveness of the treatment plan; strategies and management system which have been set up to effectively manage the risk.

Risks need to be monitored periodically to ensure that changing circumstances do not alter the risk priorities. Very few risks will remain static, therefore the risk management process needs to be regularly repeated, so that new risks are captured in the process and effectively managed.

The results of the decisions made and implemented in the various steps must be monitored to evaluate the insight of those decisions and to determine whether changing conditions suggests different solutions.

In the final stage, the risks elements identified and evaluated will be communicated to personnels at different levels in the organization for consultation and initiating suitable measures to mitigate the loss.

TRADE OFF BETWEEN RISK AND RETURN

A fundamental investment concept is the trade-off between risk and return. This concept is based on two realities i.e., investments and investment performance.

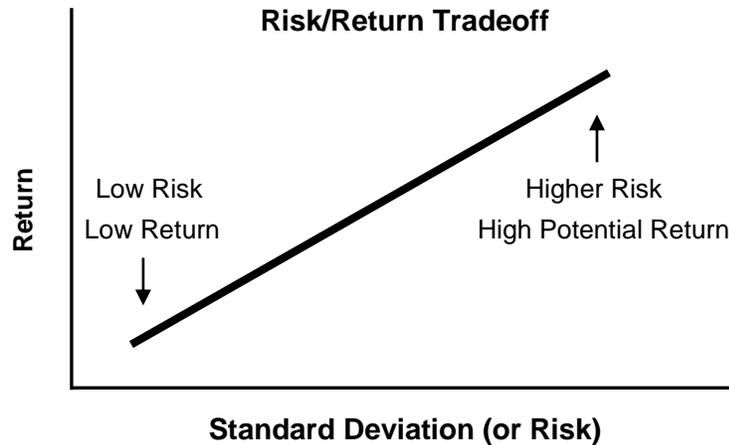
First, all investments carry some degree of risk, the reality that one could lose some or all of his money when he buy shares, bonds, mutual funds or other investments. Second, not only different types of investments carry different levels of risk, but the more risk one assume, the greater the investment return one is likely to achieve.

Risk in an organization arises in various forms, but when one talks about the risk-return trade-off, the primary measure of risk is volatility, or the degree to which an investment fluctuates in price. Different asset categories are subject to different levels of price fluctuation.

In short:

- The return earned on investments represents the marginal benefit of investing.
- Risk represents the marginal cost of investing.

- A trade off always arises between expected risk and expected rate of return.



The risk-return relationship is a fundamental concept in every aspect of life. If decisions are to lead to benefit maximization, it is necessary that individuals and institutions consider the combined influence on expected future return or benefit as well as on risk-cost. The requirement that expected return-benefit be commensurate with risk-cost is known as the "risk-return trade-off" in finance.

It is known that the major determinant of the required return on the asset is its degree of risk. Risk refers to the probability that the return and the value of an asset or security may have alternative outcomes. Risk is the uncertainty (today) surrounding the eventual outcome of an event which will occur in the future.

In financial analysis, the risk-return trade-off states that financial decisions which are associated with higher degree of risk must offer a higher expected rate of return and the financial decisions which are associated with the lower degree of risk must offer lower expected rate of return (see diagram above). Thus, there is a need to keep an optimal balance between risk and return for achieving the desirable result. Risk aversion is the tendency to avoid risky situations unless adequate compensation is offered.

MEASUREMENT OF RISK AND RETURN

Risk refers to variability of return from expected investment. A variety of measures have been used to capture different facets of risk. The more important ones among them are: Range, Standard Deviation and Co-efficient of Variation. Apart from this, one may also use – Sensitivity Analysis, Break Even Analysis, Simulation Analysis, Decision Tree Analysis, Value at Risk (VAR) Analysis and Cash Flow at Risk Analysis. A brief outline of the techniques of risk analysis are discussed below:

- (i) *Range*: It is the simplest measure of dispersion. It is the difference between its two extreme observations i.e. the difference between the largest and the smallest observations. It basically indicates the absolute measure of

variation in return and degree of risk. Its relative value known as co-efficient of range may also be calculated,

- (ii) *Standard Deviation*: Standard deviation is also known as root mean square deviation and is a measure of variability and risk. It may be defined as the positive square root of arithmetic mean of the squares of all the deviations of the values from their arithmetic mean. In brief, it refers to the square root of the mean of the squares of deviation from mean.
 - It can be used to compare the dispersions of two or more distributions when their units of measurements and arithmetic means are the same.
 - It is used to test the reliability of mean. A mean with less standard deviation is said to be more reliable.

This measure basically indicates degree of variability in variable.

- (iii) *Co-efficient of Variation*: It represents the ratio of standard deviation to the mean. It is a useful measure of comparing the degree of variation from one data series to another even if the mean values are drastically different from each other. In the investment world the co-efficient of variation enables us to determine how much volatility i.e. risk we are assuming in comparison to the amount of return we can expect from our investment. In other words, the lower the ratio of standard deviation to mean return, the better will be the risk return trade off.
- (iv) *Sensitivity Analysis*: It is a technique whereby the values of a variable parameter (inputs) are changed to denote different situations/assumptions and the effect of the changes is measured on the expected value of the outcome (result). To be more precise under sensitivity analysis it is possible to show that how the profitability of a project alters with different values assigned to the variables needed for the computation (unit sales prices, unit costs, and sales volume). This analysis is frequently used by the experts if the simple and discounted methods of evaluation do not show a satisfactory result in terms of profitability or rate of return.
- (v) *Break Even Analysis*: Break even analysis indicates the minimum quantity a firm should produce and sell at which loss is avoided. This analysis helps the financial manager of the organization to ensure cost recovery.
- (vi) *Simulation Analysis*: Under this technique, the decision maker in an organization may like to know the likelihood of risks. Simulation analysis helps to generate the information which can be used for developing the probability profile of a criterion of merit by randomly combining values of variables, having a bearing on the chosen criterion.
- (vii) *Decision Tree Analysis*: It is a useful technique where sequential decision making in the face of risk is involved. In other words, a decision tree is a branching diagram representing a decision problem as a series of decisions to be taken under condition of uncertainty. A present decision depends upon the past decisions and their outcomes. This analysis basically involves following four important steps—
 - (i) Identifying the problem and alternatives
 - (ii) Delineating the decision tree

- (iii) Specifying probabilities and monetary outcomes and
- (iv) Evaluation of various decision alternatives.
- (viii) *Value at Risk Analysis*: It is one of the proven and the most used measures of risks by financial institutions. VAR measures the likely change in market to market value of a portfolio, at specified time periods with certain confidence.
- (ix) *Cash Flow at Risk Analysis*: Cash Flow at risk measures the deviation of cash flows from the expected volume. In other words, it gives an idea as to how much of cash flow the portfolio might lose in a given time with given probability. It has been specifically developed for non-financial organizations with cash flow as variable.

The following two features of non-financial organization had resulted in the development of the C-far model.

Firstly, certain assets of non-financial organizations could be accurately valued at market prices.

Secondly, the risk free and continuous future cash flows represent the value of a non-financial organization. Hence, cash flows are taken as proxy for measuring risks.

MANAGEMENT OF BUSINESS RISKS

Organizations by nature manage risks and have a variety of functions that identify and manage certain risks. However, each risk function varies in its capability/impact and will influence the other risk functions. The art of managing risk is more challenging than ever. Risk managers face a wide range of demands, from working with multiple variables to finding technology solutions that generate comprehensive risk analysis. Factors such as real-time access to critical information, highly flexible framework which can quickly integrate various types of risks in alignment with organizational objectives etc., are considered as critical aspects of risk management in a business. Here, the challenge is to build systems that can handle potentially thousands of computations, measuring transactions, interest rate curves, volatility sets, and correlation sets, etc.

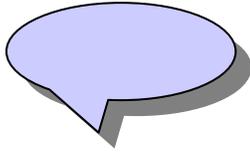
As risk management is undergoing a transformation and the risks are interlinked with each other, greater emphasis is being placed on coordination and cooperation among departments to manage the organization's full range of risks as a whole. This process of coordinated risk management generally is referred to as enterprise risk management (ERM).

Enterprise risk management is a risk-based approach to managing an enterprise, integrating concepts of strategic planning, operations management, and internal control. Enterprise risk management is evolving to address the needs of various stakeholders, who want to understand the broad spectrum of risks facing complex organizations to ensure they are appropriately managed.

The Committee of Sponsoring Organisation of the Tradeway Commission (COSO) has defined enterprise risk management as a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

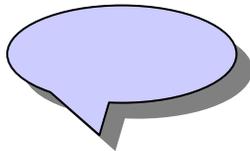
Components of ERM

According to COSO framework, there are the following eight interrelated components of risk management:



- ▶ *Internal environmental (risk management philosophy, risk appetite, risk integrity and ethical values);*
- ▶ *Setting of objectives : The objectives must be aligned with company's vision and purpose. These must be consistent with company's risk appetite;*
- ▶ *Event identification : It consists in identifying risks and opportunities associated with internal and external events which impact the objectives of the company;*
- ▶ *Risk assessment : It involves an assessment of the likelihood and impact of risks;*
- ▶ *Risk Response : The response to risk management may comprise of avoidance, acceptance, reduction or sharing;*
- ▶ *Control Activities : The Board shall frame policies which the management shall execute*
- ▶ *Information and Communication: The management may be given necessary information so that it may discharge risk management duties accordingly.*
- ▶ *Monitoring by the Board: Standard & Poor's uses the COSO framework for evaluating financial companies for the purpose of rating analysis. Moody's and Fitch also take into account risk management systems in their credit risk scoring activities.*

COSO-II has suggested that Enterprise Risk Management should take place at four levels namely:



- ▶ *Entity;*
- ▶ *Division;*
- ▶ *Business Unit; and*
- ▶ *Subsidiary.*

A central goal and challenge of enterprise risk management is improving this capability and coordination, while integrating the output to provide a unified picture of risk for stakeholders and improving the organization's ability to manage the risks effectively.

The primary risk functions in large company which may participate in an enterprise risk management program typically include the following:

- Strategic planning which identifies external threats and competitive opportunities, along with strategic initiatives to address the same.
- Compliance action which monitors compliance of law in letter and spirit.
- Marketing to satisfy the target customer and to ensure product/service alignment with customer requirements.
- Accounting/financial compliance which ensures the reporting and disclosure requirement under accounting standards and the relevant legislative provisions.
- Regulatory changes/legal trends that may impact the organization.
- Treasury that ensures cash is sufficient to meet business needs, while managing risk is related to commodity pricing or foreign exchange.
- Credit that ensures any credit provided to customers is appropriate to their ability to pay.
- Internal audit/internal control systems which evaluates the effectiveness of each of the above risk functions and recommends improvements.
- Insurance which ensures the proper insurance coverage for the organization.
- Operations management to take care of day-to-day activities,
- Customer service/complaint management which ensures prompt redressal of customer complaints.

Enterprise risk management in an organization provides enhanced capability to:

1. *Align risk appetite and strategy* – Risk appetite is the degree of risk, on a broad-based level, that a company or other entity is willing to accept in pursuit of its goals. Management considers the entity's risk appetite first in evaluating strategic alternatives, then in setting objectives aligned with the selected strategy and in developing mechanisms to manage the related risks.
2. *Link growth, risk and return* – Business organizations accept risk as part of value creation and preservation, and they expect return commensurate with the risk. Enterprise risk management thus provides an enhanced ability to identify and assess risks, and establish acceptable levels of risk relative to growth and return objectives.
3. *Enhance risk response decisions* – Enterprise risk management also provides the rigor to identify and select among alternative risk responses –

risk avoidance, reduction, sharing and acceptance. Enterprise risk management provides methodologies and techniques for making these decisions.

4. *Minimize operational surprises and losses* – Business organizations have enhanced capability to identify potential events, assess risk and establish responses, thereby reducing the occurrence of surprises and related costs or losses.
5. *Identify and manage cross-enterprise risks* – Every business unit faces a myriad of risks affecting different parts of the organization. Management needs to not only manage individual risks, but also understand interrelated impacts.
6. *Provide integrated responses to multiple risks* – Business processes carry many inherent risks, and enterprise risk management enables the integrated solutions for managing the risks.
7. *Seize opportunities* – Management considers potential events, rather than just risks, and by considering a full range of events, management gains an understanding of how certain events represent opportunities.
8. *Rationalize capital* – More robust information on an organization's total risk allows management to more effectively assess overall capital needs and improve capital allocation.

RESPONSIBILITIES ON RISK MANAGEMENT

For effective risk management in an organization, it is essential to specify the responsibilities at various levels of management. A brief outline of responsibility in this regard is summarized as follows:

- (i) *Board of Directors*: The Board has a major role in defining what it expects in integrity and ethical values and can confirm its expectations through oversight activities. Similarly, by reserving authority in certain key decisions, the board plays a role in setting strategy, formulating high-level objectives and broad-based resource allocation.

The board of directors provides oversight with regard to enterprise risk management by:

- Knowing the extent to which management has established effective enterprise risk management in the organization
- Being aware of and concurring with the entity's risk appetite
- Reviewing the entity's portfolio view of risks and considering it against the entity's risk appetite
- Being apprised of the most significant risks and whether management is responding appropriately
- The board is part of the internal environment component and must have the requisite composition and focus for enterprise risk management to be effective.

- (ii) *Chief Executive Officer*: The chief executive officer is ultimately responsible for the enterprise risk management in the organization. He sets the strategy that affects integrity and ethics and other factors of the internal environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they manage the business. Senior managers, in turn, assign responsibility for establishment of more specific risk management policies and procedures to personnel responsible for individual units' functions.
- (iii) *Risk Officer*: A risk officer works with other managers in establishing and maintaining effective risk management in their areas of responsibility. The risk officer also may have responsibility for monitoring progress and for assisting other managers in reporting relevant risk information up, down and across the organization and may be a member of an internal risk management committee.
- (iv) *Internal Auditors*: Internal auditors play a vital role in monitoring of enterprise risk management and the quality of performance as part of their regular duties or upon special request of senior management or subsidiary or divisional executives. They may assist both management and the board or audit committee by monitoring, examining, evaluating, reporting on and recommending improvements to the adequacy and effectiveness of management's enterprise risk management processes.
- (v) *Other Personnel*: Enterprise risk management is the responsibility of everyone in an entity and therefore should be an explicit or implicit part of everyone's job description. Virtually all personnel produce information used in enterprise risk management or take other actions needed to manage risks.

A number of external parties often contribute to achievement of an entity's objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and internal control examinations, and indirectly by providing additional information useful to management and the Board in carrying out their responsibilities. Others providing information to the organization useful in effecting enterprise risk management are regulators, customers and other transacting business with the enterprise, financial analysts, bond raters and the news media. External parties, however, are not responsible for the entity's enterprise risk management.

STRATEGIES FOR RISK MITIGATION

Once risks have been identified and assessed, the strategies to manage the risk fall into one or more of the following categories:

- (i) *Transfer Risk*: Normally in projects assignments or multifaceted exercises, execution is fought with risks. Different agencies work together and these agencies take care to transfer risk in their areas to another agency which is better equipped to take care of a risk for a consideration. Here the concept of core competence curves in and whenever a particular agency, individual or a firm finds that it is dealing in an area where it does not have the core competence to deal with it seeks the help of another agency which has the specific core competence to transfer its own risk. The risk may be in the

form of loss of reputation or sub quality performance and this risk is taken care of through transfer.

- (ii) *Tolerate Risk*: It is retention of the risk. It is accepting the loss when it occurs. True self insurance falls in this category. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained. All risks that are not avoided, reduced or transferred are retained by default. This includes risks that are so large or catastrophic that they either cannot be insured against or the premiums would be infeasible.

War is an example since most property and risks are not insured against war, so the loss attributed by war is retained by the insured. Also any amount of potential loss (risk) over the amount insured is retained risk. This may also be acceptable if the chance of a very large loss is small or if the cost to insure for greater coverage amounts is so great it would hinder the goals of the organization too much.

- (iii) *Reduce Risk*: By far the greater number of risks will belong to this category. The purpose of treatment is not necessarily to obviate the risk, but more likely to contain the risk to an acceptable level. Internal controls are actions instigated from within the organization (although their effects may be felt outside of the organization) which are designed to contain risk to acceptable levels.

Outsourcing could be an example of risk reduction if the outsourcer can demonstrate higher capability at managing or reducing risks. In this case companies outsource only some of their departmental needs. For example, a company may outsource only its software development, the manufacturing of hard goods, or customer support needs to another company, while handling the business management itself. This way, the company can concentrate more on business development without having to worry as much about the manufacturing process.

Modern software development methodologies reduce risk by developing and delivering software incrementally. Early methodologies suffered from the fact that they only delivered software in the final phase of development; any problems encountered in earlier phases meant costly rework and often jeopardized the whole project.

- (iv) *Avoid Risk*: This method results in complete elimination of exposure to loss due to a specific risk. It can be established by either avoiding to undertake the risky project or discontinuance of an activity to avoid risk. This means that no risky projects are undertaken. Alternatively, a project may be abandoned midway to mitigate the risk while handling a project.

It is not performing an activity which could carry risk. An example would be not buying a property or business in order to not take on the liability that comes with it. Another would be not flying in order to not take the risk that the aeroplanes were to be hijacked. Avoidance may seem the answer to all risks, but avoiding risks also means losing out on the potential gain that accepting (retaining) the risk may have allowed. Not entering a business to avoid the risk of loss also avoids the possibility of earning profits.

- (v) *Combine Risk*: When the business faces two or three risks the overall risk is reduced by combination. This strategy is suitable mainly in the areas of financial risk. Different financial instruments say, shares and debentures are taken in a single portfolio to reduce the risk.
- (vi) *Sharing Risk*: Insurance is a method of sharing risk for a consideration. For example by paying insurance premium the company shares the risk with companies and the insurance companies themselves share their risk by doing re-insurance.
- (vii) *Hedging Risk*: Exposure of funds to fluctuations in foreign exchange rates, prices etc., bring about financial risks resulting in losses or gain. The downside risk is often taken care.

MAINTAINING THE RISK STRATEGY

It has already been noted that the risk environment of any organization is constantly changing and developing, and that the priorities of objectives and the consequent importance of risks will shift and change. The risk management process is therefore a dynamic and ongoing one, not an issue for a one off exercise. The process has to allow for periodic review of risks and for consequent adjustment of the control response.

Whatever option is adopted, it is important that those charged with control of the risk management process should regularly review it. One useful technique for doing this is to actively review the risks associated with each of the key organizational objectives.

Suitable tools needs to be identified to assist with the task of keeping the risk strategy up-to-date. A key tool is the use of ongoing Control and Risk Self Assessment (CRSA) procedure. This procedure embeds review of risk and control into the organization at every level and uses the knowledge and experience of the staff that are closest to each function to assess the movement in risks and the appropriateness of control.

Illustration:

Infosys' Enterprise Risk Management

Infosys, India's IT giant has based its business model on four pillars namely: (i) Predictability; (ii) Sustainability; (iii) Profitability; and (iv) De-risking. De-risking allows the company to react effectively to changes in the business environment. As a consequence, the company is enabled to generate predictable and sustainable revenues. Enterprise risk management system adopted by the company is a comprehensive and integrated risk management framework. Formal reporting and control mechanisms are used to ensure timely availability of information. Prudential norms limit exposure. The risks at transactional level are identified and risk mitigation measures are taken. Risk management responsibility vests in the Board which monitors the risk levels. Risk mitigation measures are implemented by the management council. The feedback on risks is provided by the audit committee. The following are some of the risks identified by the company:

► *Concentration Risks* arising from excessive concentration in any one vertical technology, client or geographic area. To deal with this kind of risk, an array of service offerings across various horizontal and vertical business segments have been developed. Following the dotcom collapse the company has reduced its exposure to high risk internet start-up companies.

► *Contractual Risks*: The legal risks involved in contracts are assessed. The company adopts elaborate review and documentation process for contracts. Insurance covers are taken with regard to foreign contracts to cover liabilities from non-performance of contracts. Management review is done on a continuous basis and corrective action undertaken. The company does not make contracts exposing it to open ended liabilities.

► *Human Resource Risks*: The company regards employees as its key resources. To encourage people to innovate, the company attempts to create a favourable work environment and rewards merit. During recession the attrition rate was kept at 7.6 percent (2002).

► *Operational Risks*: The company regards risk management at the operational level as the key requirement for reducing uncertainty in delivering high quality software solutions within budgeted time and cost. The company uses quality models such as Software Engineering Institute's Capability Maturity Models (SEI--CMM) to ensure that risks are identified and measures taken to mitigate them at the project planning stage.

► *Risk Management Guidelines*: Guidelines are provided to project leaders and module leaders on how risks could be identified and mitigated.

► *Foreign Currency Risk*: A substantial part of company's revenues is dollar denominated. Its business operations extend over more than 30 companies. Most of its contracts are consequently denominated in internationally tradable currencies. The company has minimal exposure to non-tradable currencies or those which may depreciate quite sharply.

Illustration

Incentivizing good project management: The wrong V. the right approach.

In a company, the project managers were rewarded for correcting the problems in troubled projects. A manager assigned to a project which was in death bed could claim sizable performance bonus if he could restore the project to good health. The corporate management considered this to be the proper way to motivate the employees to evince exceptional performance.

One of the project managers who fully understood the incentive system began to covertly allow his projects to deteriorate slowly until they were on the brink of cancellation. Then with every heroic effort, he would resuscitate them. His herculean efforts would earn him substantial bonus time and again. Unfortunately

the higher management finally found out that he was the main cause for the problem. He was summarily dismissed.

What was the default in this strategy?

The higher management of the company failed to ensure that the project manager's best interest coincided with the company's best interest. If the company wanted to have projects that were healthy all throughout their life time, then the incentive to project managers should have been geared to keeping the project healthy.

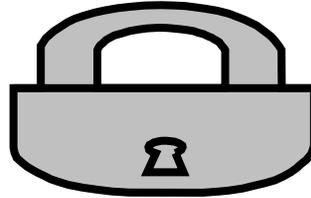
The managers whose projects never faltered should have received greater bonuses than the managers whose projects suffered and later recovered. Rather than firing the manager, the company should have changed its incentive system and let the manager flourish in an environment that would simultaneously benefit both the company and the staff.

A case study on Risk Management together with Internal Control is given in Chapter-8.

LESSON ROUND UP



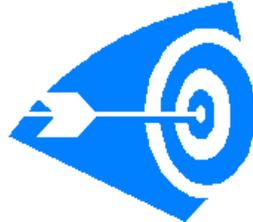
- Risk is an uncertainty of outcome, whether positive opportunity or negative threat, of actions and events. It refers to the uncertainty that surrounds future events and outcomes.
- Risk management is as much about identifying opportunities as avoiding or mitigating losses.
- The objective of risk management is to reduce different risks related to a preselected domain to the level accepted by society.
- Risk management should be most rigorously applied where critical decisions are being made. Decisions about risk will vary depending on whether the risk relates to long, medium or short term goals.
- Profits are created through business activity. Risk and business come together more often.
- A certain amount of risk taking is inevitable if an organization is to achieve its objectives.
- Enterprise risk management is a risk-based approach to managing an enterprise, integrating concepts of strategic planning, operations management, and internal control.

SELF TEST QUESTIONS

1. Describe the meaning and types of risks.
 2. Explain the process involved in risk management.
 3. Describe the role of enterprise risk management in business organizations.
 4. Explain the following:
 - (i) Systematic and unsystematic risk
 - (ii) Market risk and business risk.
 5. Describe the concept of risk return trade-off.
 6. Discuss the various techniques involved in the measurement of risk and return.
 7. What is enterprise risk management process? Explain.
 8. Explain the strategies for risk mitigation.
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STUDY VII
MANAGEMENT INFORMATION SYSTEMS

LEARNING OBJECTIVES



The object of this study lesson is to enable students to understand:

- Concept, Evolution, Elements and Definition of MIS
- Structure of MIS
- Computerized MIS
- Approaches of MIS Development
- Pre-requisites of an Effective MIS
- Computers and its Effect on MIS
- Impact of Computers and MIS on Different Levels of Corporate Management
- Constraints in operating a MIS and Limitations in MIS
- MIS vs Data Processing
- MIS and Decision Support Systems
- MIS and Information Resource Management
- Executive Information System and Decision Support Systems
- Expert System
- Entrusting Enterprise in a Corporate Enterprise
- MIS in Indian Organisations
- Enterprise Resource Planning.

MIS - CONCEPT

Executives in an organization provide leadership and direction for planning, organizing, staffing, supervising, and controlling business activities. Each of these business activity involves decision making process. For making decisions, executives need the information. The required information is to be provided by information specialist or by data processing department. With the increasing competition in the era of information and knowledge based economy, the demands for organized, need base information is increasing day by day.



The main purpose of MIS is to provide timely, specific and accurate information at all levels in an organization. To achieve this goal, different types of information systems are devised by the organizations.

The MIS is derived from these information systems used in the organizations. It is a broad concept rather than the single system. Some MIS activities are highly integrated with routine data processing, while other MIS applications are designed for a particular knowledge work activity or decision making function.

A well-defined MIS provides information to all levels of management for the following purpose:

- To define the objectives of the organization.
- To formulate strategies and policies to achieve the objectives set by the management.
- To report the organization performance to tax authorities, shareholders, regulatory authorities and other stakeholders such as suppliers and customers etc.
- To prepare future plans for short and long term basis.
- To exercise day-to-day control on various operations in the different functional areas in the organization.
- To allocate different type of resources to different functional areas.
- To allow management by exception.
- To develop database of business partners and to devise procedures to deal with them.
- To develop the training tools for the new recruits in the organization at all levels.

EVOLUTION OF MIS

MIS is an age-old concept used to manage the various activities in the organizations. Before the emergence of electronic computing machine, it was existing in its manual form. It has been used as a means to develop structured decision making processes in the organizations at all levels for internal as well as external controls. However, in early days specifically in a monopoly situation, it is being used as a tool of analyzing and developing routine reports mainly related to major parameters of business activities. These reports are simple and numeric in nature. In some cases, simple analysis relating achievements and targets is reported. But today in the era of information and knowledge based economy and free markets, the success of an organization largely depends on its information systems. As far as its evolution is concerned, it can be linked to the following four disciplines.

1. Management Accounting

The field of accounting consists of two major areas, i.e. financial accounting and management accounting. Financial Accounting is concerned with measurement of

income for specific periods of time such as a month or a year and the reporting of financial status at the end of the period. The first one is known as an income statement and other one as balance sheet. Though it is very important to see the status of finances but these two statements are of limited use as far as managerial decision making is concerned. In fact these statements are more relevant to the investors. The other branch of accounting, i.e., Management Accounting deals with relevant costs and other analysis useful for managerial control and managerial decisions. It employs techniques such as capital budgeting, break even analysis, transfer pricing etc. Its focus is on the preparation of budgets and measurement of performance based on the budgets. It is oriented towards internal controls and management decisions. Historically, accounting department was always responsible for data processing because the first application of processed data was related to accounting function. Management accounting information was used to carry analysis, to identify specific information requirement of executives for performing their functions in their respective departments. For example, to determine the break-even point, the information requirement are fixed costs, variable cost and the selling price of the product. To find out economic order quantity one needs to know carrying cost, holding cost, product demand for the year and purchasing cost/order cost.

These set of information are always a part of MIS, therefore the birth of MIS can be traced to management accounting. However, the support systems which provide users with access to data and models are beyond the scope of traditional management accounting.

2. Management Science/Operational Research

Management Science/Operational Research is the application of scientific method and quantitative analysis techniques (or Operations Research Techniques) to management problems. The use of management science methods emphasizes on the use of systematic approach to problem solving and application of scientific method to investigation. It utilizes mathematical models and mathematical and statistical procedures for analyzing problems. Finally, it aims at achieving optimal decision of optimum policy.

Management Science techniques were incorporated in the DSS which is a component of MIS, to make quantitative and analytical information available to the users of MIS. The information systems make use of models, and computer based solution algorithms. In addition, these systems provide quantitative information and procedures to facilitate model building for future plans and activities and to simulate the real situation even before they occur.

3. Management and Organization Theory

MIS is a support system for organizational functions, therefore, it draws upon concepts of organization, organization behavior, management, and decision making. The field of management and organization theory has provided many important concepts and philosophies which are key to understand the functions of MIS. Some of these concepts are:

- Behavioral theory of organizational and individual decision-making.
- Individual motivation.
- Group processes and group decision making.
- Leadership techniques.

- Organizational change process.
- Organizational structure and design.

There are several management theories-behavioral, empirical, decision, quantitative and management process. Out of these decisions, quantitative and management process are more relevant to us. According to decision theory, the most important task of managers is to make decisions.

The second theory known as "Management Process" is the most widespread approach of management. Under this, management is defined in terms of what managers do. According to this, management performs the functions of planning, organizing, staffing, directing and controlling.

The knowledge of these management theories enabled the MIS designers to ascertain the type of decisions made and functions performed by executives in business organizations.

4. Computer Science

Computers were not originally planned for processing information but today this is the major use for which they are applied in business situations. The reasons for this are their speed of processing, calculating and retrieval of data. In fact, computer technology has been considered as a major factor in inducing MIS development. It has come as a significant tool in information processing and storage.

From the above discussion, it is quite apparent that MIS has been evolved from various disciplines in management. It maintained and provided the necessary information to its executives for planning, controlling and decision-making purposes. For example, control of inventory is an important management function. At the time when no integrated MIS was in use, perhaps the inventory in-charge managed the function based on the information emanating from his department like the information that certain items have been exhausted or are nearing exhaustion. He would then have taken steps to replenish the stocks in the usual manner. However, with the development, the information which he needs now includes-cost of maintaining inventories, purchase schedule, economic order quantities, lead time, rate of consumption, etc.

In this approach of integrated MIS, management theories and specially the financial management concepts have contributed the enrichment. Further, when one has to manage a very large number of inventories here, he takes the aid of computer.

Illustration:

Information System in Restaurant

A waiter takes an order at a table, and then enters it online via one of the six terminals located in the restaurant dining room. The order is routed to a printer in the appropriate preparation area: the cold item printer if it is a *salad*, the hot-item printer if it is a hot *sandwich* or the bar printer if it is a *drink*. A customer's meal check-listing (bill) the items ordered and the respective prices are automatically generated. This ordering system eliminates the old three-carbon-copy guest check system as well as any problems caused by a waiter's handwriting. When the kitchen runs out of a food item, the cooks send out an 'out of stock' message, which will be displayed on the

dining room terminals when waiters try to order that item. This gives the waiters faster feedback, enabling them to give better service to the customers. Other system features aid management in the planning and control of their restaurant business. The system provides up-to-the-minute information on the food items ordered and breaks out percentages showing sales of each item versus total sales. This helps management plan menus according to customers' tastes. The system also compares the weekly sales totals versus food costs, allowing planning for tighter cost controls. In addition, whenever an order is voided, the reasons for the void are keyed in. This may help later in management decisions, especially if the voids consistently related to food or service. Acceptance of the system by the users is exceptionally high since the waiters and waitresses were involved in the selection and design process. All potential users were asked to give their impressions and ideas about the various systems available before one was chosen.

Questions

1. In the light of the system, describe the decisions to be made in the area of strategic planning, managerial control and operational control? What information would you require to make such decisions?
2. What would make the system a more complete MIS rather than just doing transaction processing?
3. Explain the probable effects that making the system more formal would have on the customers and the management.

Solution:

1. A management information system (MIS) is an organized combination of people, hardware, communication networks and data sources that collects, transforms and distributes information in an organization. An MIS helps decision making by providing timely, relevant and accurate information to managers. The physical components of an MIS include hardware, software, database, personnel and procedures.

Management information is an important input for efficient performance of various managerial functions at different organization levels. The information system facilitates decision making. Management functions include planning, controlling and decision making. Decision making is the core of management and aims at selecting the best alternative to achieve an objective. The decisions may be strategic, tactical or technical. Strategic decisions are characterized by uncertainty. They are future oriented and relate directly to planning activity. Tactical decisions cover both planning and controlling. Technical decisions pertain to implementation of specific tasks through appropriate technology. Sales region analysis, cost analysis, annual budgeting, and relocation analysis are examples of decision-support systems and management information systems.

There are 3 areas in the organization. They are strategic, managerial and operational control.

Strategic decisions are characterized by uncertainty. The decisions to be made in the area of strategic planning are future oriented and relate directly to planning activity. Here basically planning for future that is budgets, target markets, policies,

objectives etc. is done. This is basically a top level where up-to-the minute information on the food items ordered and breaks out percentages showing sales of each item versus total sales is provided. The top level where strategic planning is done compares the weekly sales totals versus food costs, allowing planning for tighter cost controls. Executive support systems function at the strategic level, support unstructured decision making, and use advanced graphics and communications. Examples of executive support systems include sales trend forecasting, budget forecasting, operating plan development, budget forecasting, profit planning, and manpower planning.

The decisions to be made in the area of managerial control are largely dependent upon the information available to the decision makers. It is basically a middle level where planning of menus is done and whenever an order is voided, the reasons for the void are keyed in which later helps in management decisions, especially if the voids are related to food or service. The managerial control that is middle level also gets customer feedback and is responsible for customer satisfaction.

The decisions to be made in the area of operational control pertain to implementation of specific tasks through appropriate technology. This is basically a lower level where the waiter takes the order and enters it online via one of the six terminals located in the restaurant dining room and the order is routed to a printer in the appropriate preparation area. The item's ordered list and the respective prices are automatically generated. The cooks send 'out of stock' message when the kitchen runs out of a food item, which is basically displayed on the dining room terminals when waiter tries to order that item. This basically gives the waiters faster feedback, enabling them to give better service to the customers. Transaction processing systems function at the operational level of the organization. Examples of transaction processing systems include order tracking, order processing, machine control, plant scheduling, compensation, and securities trading.

The information required to make such decision must be such that it highlights the trouble spots and shows the interconnections with the other functions. It must summarize all information relating to the span of control of the manager. The information required to make these decisions can be strategic, tactical or operational information.

Advantages of an online computer system :

- Eliminates carbon copies
- Waiters' handwriting issues
- Out-of-stock message
- Faster feedback, helps waiters to service the customers

Advantages to management:

- Sales figures and percentages item-wise
- Helps in planning the menu
- Cost accounting details

2. If the management provides sufficient incentive for efficiency and results to their customers, it would make the system a more complete MIS and so the MIS should support this culture by providing such information which will aid the promotion of efficiency in the management services and operational system. It is also necessary to study the keys to successful Executive Information System (EIS) development and operation. Decision support systems would also make the system a complete MIS as it constitutes a class of computer-based information systems including knowledge-based systems that support decision-making activities. DSSs serve the management level of the organization and help to take decisions, which may be rapidly changing and not easily specified in advance.

Improving personal efficiency, expediting problem solving (speed up the progress of problems solving in an organization), facilitating interpersonal communication, promoting learning and training, increasing organizational control, generating new evidence in support of a decision, creating a competitive advantage over competition, encouraging exploration and discovery on the part of the decision maker, revealing new approaches to thinking about the problem space and helping automate the managerial processes would make the system a complete MIS rather than just doing transaction processing.

3. The management system should be an open system and MIS should be so designed that it highlights the critical business, operational, technological and environmental changes to the concerned level in the management, so that the action can be taken to correct the situation. To make the system a success, knowledge will have to be formalized so that machines worldwide have a shared and common understanding of the information provided. The systems developed will have to be able to handle enormous amounts of information very fast.

An organization operates in an ever-increasing competitive, global environment. Operating in a global environment requires an organization to focus on the efficient execution of its processes, customer service, and speed to market. To accomplish these goals, the organization must exchange valuable information across different functions, levels, and business units. By making the system more formal, the organization can more efficiently exchange information among its functional areas, business units, suppliers, and customers.

As the transactions are taking place every day, the system stores all the data which can be used later on when the hotel is in need of some financial help from financial institutes or banks. As the inventory is always entered into the system, any frauds can be easily taken care of and if anything goes missing then it can be detected through the system.

Source: scribd.com

ELEMENTS OF MIS

MIS is a system that helps management in the process of decision making. The three elements of MIS are Management, Information and System. It is necessary to understand these three components:

(a) Management

The term “Management” as defined by Marry Follett is “The art of getting things done through people”. It also refers to a set of functions and processes designed to initiate and coordinate group efforts in an organized setting, directed towards promoting certain interests, preserving certain values and pursuing certain goals. It involves mobilization, combination, allocation and utilization of physical, human and other needed resources in a judicious manner by employing appropriate skills, approaches and techniques. It is a process of conceiving and converting certain worthwhile ideas into results by getting things done through people by offering them monetary and other inducement in return for their contributions.

In short “Management” may be thought of as the sum total of these activities which relate to the laying down of certain plans, policies and purposes, securing men, money, materials and machinery needed for their goal achievements; putting all of them into operation, checking their performance and providing material rewards and mental satisfaction to the men engaged in the operation.

(b) Information

It is a source for increment in knowledge. In MIS, it is obtained by processing data in to a form meaningful to the users.

Illustration:

Let us discuss the following situations; if some body throws the word eleven during discussion, it means nothing to the participant. It is a data item, but it is placed within a context familiar to the intended recipient. Let us analyze another situation, if a manager is asking a question, “What are the sales of the packaged goods by marketing department and projection for the next quarter?” The answer would be 11 only. Here, it is information not the data item since the number 11 is being used in a context. Some of the important characteristics of useful and effective information include timeliness, purposeful, mode and format, completeness, reliability, validity, quality, frequency etc.

(c) System

A physical system is a set of components that operate together to achieve a common objective or multiple objectives. These objectives are realized in the outputs of the system. An efficient system uses its inputs economically in producing its outputs. An effective system produces the outputs that best meet the objectives of the system. The objective of the management information system is to provide formal informational support to the members of the organization.

MANAGEMENT LEVELS AND THEIR INFORMATION NEEDS

The levels of management consist of top, middle, and first line management (supervisory). The activities in the organizations are of three types:

- Strategic planning,
- Tactical and
- Operational.

Each of these levels perform - strategic planning, tactical, and operational activities and requires different set of information. The activities, and information needs of three levels of management are discussed as under:

(a) Top level (Strategic level) Management and their information requirements

Top management is defined as a set of management positions, which are concerned with the overall tasks of designing, directing and managing the organization in an integrated manner. They are responsible for interacting with representatives of the external environment, such as financial institutions, political figures, and important clients of the organization.

The structure of top level management normally consists of Chairman and members of the Board of Directors, Chief Executive Officer and the heads of the major departments of the company. In fact, this level consists of those executives, whose responsibilities relate to the whole organization or in other words, they are accountable for effectiveness and efficiency of the operations of the organization as a whole.

Top management's main responsibility is in the direction of determining the overall goals and objectives of the business. It deals mainly with long-term strategic plans, policy matters and broad objectives of the company. Also, it establishes a budget framework under which the various departments will operate.

Information Needs

Top management needs the information on the trends in the external environment (economic, technological, political and social) and on the functioning of the internal organizational sub-system. Apart from historical information, top management requires on-going or current information also which is generated through forecasts of the future. Thus, mostly the information utilized by top management is futuristic and external in nature. Much of the information so generated for strategic planning purpose tends to be incomplete and not fully reliable. It may not be available on time. For control purposes, top management receives summary and "exception reports" (For example on production, sales, cash, profits, and so on) from the middle management. The distinction between strategic planning information requirement and tactical information requirement is not always clear because both systems use some of the common information. The strategic planning information often have the following characteristics.

- (i) **Ad hoc Basis:** The information may be produced either regularly or periodically. For example, top management uses periodic accounting system reports such as the income statement, balance sheet, statement of sources and uses of funds, and capital statements in its planning functions. However, strategic planning information is more often produced when it is needed, on an ad hoc basis.
- (ii) **Unexpected Information:** The information produced by the system may not be the same that was anticipated. For example, economic forecast information may be requested for the economy as a whole and for the industry in particular. The result of the economic forecast may be a surprise to the organization planners.
- (iii) **Predicted nature:** The information produced is usually predictive of the future events rather than descriptive of past events. Long range planners try

to set a course for an organization through an uncharted future. Their primary task is to choose a route that will improve the organization's level of success.

- (iv) **Summary Form:** The information produced is usually not detailed but in summary form. Long range planners are not usually interested in detailed information, they are concerned with more global data. For example strategic planners may not be interested in the customer invoices but overall buying trends for their product vis-à-vis the product of the competitors.
- (v) **External Data:** A large part of data used for input to the system is acquired from the external sources. To mention, rate of borrowed capital, investment opportunities, demographic characteristics of a market group, and economic conditions etc. and the example of this type of information.
- (vi) **Unstructured format:** The data used for input to the system may contain data that are unstructured in format. For example: forecasts of future stock market trends may be using the opinions of stock buyers, sales people, or market analysts obtained in casual conversations.
- (vii) **Subjectivity:** The input to the system may be highly subjective in nature.

(b) Middle level (Tactical level) Management and their Information Needs

Middle level management is defined as a group of management positions, which tend to overlap the top and supervisory management levels in the hierarchy. Middle management positions consist of heads of functional departments and chiefs of technical staff and service units. Middle management, therefore, includes such people as the Manager of Sales, the Manager of Purchase, Finance Manager, and the Manager of Personnel etc.

Middle management may be viewed as "administrative" management in the sense that it is responsible for the elaboration, classification and operationalization of organization goals, strategies and policies in terms of action programmes and norms of performance. Middle management is basically concerned with the task of formulating pragmatic operating policies and procedures for the guidance of supervisory management.

The nature of information required at the middle management level is less diverse and complex. Middle management is fed with information both from top management and supervisory management. Much of the information used by the middle management is internal in nature. Middle management does not require much "futuristic" information since its decisions are not strategic and long range in nature.

Illustration:

The information needs of a sales manager are: corporate sales goals and targets, strategies and policies for operationalising them, he also needs information on sales potential and trends in different market segments, geographical territories, competitive conditions and so on. Further, he needs information on weekly sales turnover from different zones and for different products, customer complaints, delay in dispatches, finished goods inventory position and the like for the purposes of control.

Tactical Information Systems are designed to generate a variety of reports, including summary reports, exceptional reports, and ad hoc reports. Some of the features of these systems are summarized below:

- (i) *Predictive Nature:* The information from a tactical system is sometimes produced periodically. For example, a branch credit manager for an organization may receive a weekly report showing the total dollar amount of accounts that are more than 60 days overdue, 90 days overdue, and in hands of a collection agency. The report might compare the three amounts with the same data from other branches of the organization. The same data can be compared for different time periods may be this year and last two years to see the trends. Based on this information, credit manager can decide whether the overdue account totals are within the normal range for the branch or whether the difference between the amounts warrants special managerial action or decisions. Thus, this information system provides the means by which the credit manager can quickly identify problems and bring them under control. On the other hand, tactical information systems can produce information when it is needed on ad hoc basis.
- (ii) *Unexpected Findings:* The information provided by a tactical information system may not be the information that was expected to be produced. For example: querying an accounting system database, a manger can find the characteristics of major customer related to credit difficulty. It may have relation with customer position and type of employer. Investigation may reveals that overdue problem is with those customer whose employer had a cut in its workforce. The unemployment of these customers is creating a over due problem. As a credit agency, it has to analyze the purchasing of these customers afresh.
- (iii) *Comparative Nature:* The information produced is usually comparative in nature rather than merely descriptive. They provide managers with information that alerts them to major variation from the accepted standards. These types of information systems are similar to the control process systems which monitor output of the system continuously and provide feedback when output parameters are at variance with accepted standards.
- (iv) *Summary Form:* The information produced is not detailed but is in summary form, however, in comparison to the strategic planning systems, it may be more elaborate. For example: a credit manager is not interested in a detailed listing of each customer account and its balance. In large organizations, there would be an enormous quantity of data and would not, therefore, be information to the manager. The manager need information relating to credit performance or balances of accounts that are overdue or in collection.
- (v) *Both External and Internal Sources:* The data used, as input to the system may not always confine to sources internal to the organization. It may be from external sources also. For example: the credit manager may compare the information pertaining to problems to other branches, to other periods from the same organization, or to a goal set up by top management. The credit manager may sometimes like to compare it with the experience of the whole industry.

(c) Supervisory level

Supervisory management is defined as a team of management positions at the base of the hierarchy. It consists of section officers, office managers and superintendents, foreman and supervisors who are directly responsible for instructing and supervising the efforts of rank and file, clerical and “blue-collar” employees and workers.

Supervisory management is also called operation management” in the sense that it is concerned with implementing operational plans, policies and procedures for purposes of conversion of inputs into outputs.

At the supervisory level, managers are responsible for routine, day-to-day decision and activities of the organization, which do not require much judgement and discretion. The function and process of the supervisory management are standardized as far as possible. The perspective of supervisory management is generally short-range and insular. It functions in a relatively closed environment.

Supervisory management mostly needs internal information on operational aspects of the functioning of activity units. It in fact, generates internal information for example, on purchase and sales, production, use of inputs etc., at the operating level. It also receives information from the middle management levels on operational plans and programmes. The nature of information is routine and structured. It tends to be reliable and relatively complete. There is little element of complexity of uncertainty involved in the information.

The major characteristics of Information Systems are as follows :

- (i) *Repetitiveness*: The information produced by these systems is usually repetitive in nature at periodic intervals such as daily, weekly, or monthly.
- (ii) *Predictability*: The information they produce usually does not contain any surprises for the manager or the users of the information. These systems produce results at the expected time. For example: People are paid by the system what they are expected to be paid and customers are billed for what they purchased.
- (iii) *Emphasis on the past*: The information generated by the systems usually describe the past. For example: payroll accounting systems describes the work done by the employees in the past for which they are being paid. Invoices describe past sales to customers.
- (iv) *Detailed nature*: The information produced is very detailed. To mention, as an example, paychecks provide detailed information on the work week of each employee along with all allowances and deductions. Customer invoices describes the details of purchases.
- (v) *Internal origin*: The data for operational system usually spring entirely from internal sources. The data for paychecks come from internal documents of the organization.

- (vi) *Structured form*: The form of the data input and the form of the output produced by the operational information systems is structured. That is the data on time cards for each employee are carefully formatted in identical fashion. Or the data on each customer invoice are carefully formatted in identical fashion.
- (vii) *Great accuracy*: The accuracy of the data used as input to such systems and of the output produced by such systems is usually very high. The data input and information output are carefully checked in a variety of ways.

DEFINITION OF MIS

Definition: Many researchers have defined the word MIS. Few of these definitions are given below:

Definition 1 (Canith): Canith defines MIS as an approach that visualizes the business organization as a single entity composed of various inter-related and inter-dependent sub-systems looking together to provide timely and accurate information for management decision making, which leads to the optimization of overall enterprise goals.

Definition 2 (Dicky): He defines MIS “as an approach to information system design that conceives the business enterprise as an entity composed of inter-dependent system and sub-systems, which with the use of automated data processing systems, attempts to provide timely and accurate management information which will permit optimum management decision-making”.

Definition 3 (Schwartz): The MIS definition presented by Schwartz is “a system of people, equipment procedures, documents and communications that collects, validates, operates on, transformers, stores, retrieves, and presents data for use in planning, budgeting accounting, controlling and other management process”.

Definition 4 (George M. Scott): His definition is “Management Information System is a comprehensive, coordinated information subsystems which are rationally integrated and which transform data into information in a variety of ways to enhance productivity in conformance with manager styles and characteristics on the basis of established criteria”.

Definition 5 (Frederick B. Cornish): He states that a proper Management Information system is “structured to provide the information needed when needed and where needed”, further, the system “represents the internal communications network of the business providing the necessary intelligence to plan, execute and control”.

The Management Information Systems operating these days are based on computers so much that some authorities consider them as inseparable from computers.

MIS is defined as a “computer based network containing one or more operating systems, provides relevant data to management for decision-making purposes and

also contains the necessary mechanism for implementing changes of responses made by management in this decision-making”.

-Thomas R. Prince

Computers do assist greatly in operating MIS in big industrial or commercial concerns but it would be wrong to think that such a system cannot be operated without the help of computers.

Definition 6 (Coleman and Riley) : An MIS (i) applies to all management levels; (ii) and is linked to an organization sub-system; (iii) function to measure performance, monitor progress, evaluate alternatives or provide knowledge for change or corrective action; and (iv) is flexible, both internally and externally.

Definition 7 (G. B. Davis): He defines management information system as “an integrated man/machine system for providing information to support the operations, management and decision-making functions in an organization”. The system utilizes computer hardware and software, manual procedures, management and decision models, and a data base. According to him, managerial information structure must be of a pyramidal shape and it should be in conformity with the pyramidal pattern of the structure of the particular organization, i.e., at higher levels the information needed is more filtered and brief but meaningful whereas lower the level the broader should be the information base.

Definition 8 (Jerome Kanter): According to Jerome Kanter, “MIS is a system that aids management in making, carrying out, and controlling decisions”. Here MIS is a system that aids management in performing its job. MIS does not imply that it aids all levels of management. Frequently, a computerized MIS is taken to mean a system that reacts instantaneously to top management requests, pouring out data that shows the status of the company at 60-second intervals in graphic form on television screens. A company can employ MIS concepts that focus on middle and operating management rather than top management.

CHARACTERISTICS OF MIS

Some of the main characteristics of MIS based on above definitions are listed as under:

- (i) *Comprehensiveness*: Management Information System is comprehensive in nature. It includes transactions processing systems and information systems designed primarily for managers at all levels. It also embraces other systems such as formal and informal systems, manual and computer systems, project information systems, office information systems, forecasting information systems, intelligence information systems, decision support systems and other computer models which process business data and numerous other specialized structurally distinctive information system.
- (ii) *Co-ordinated*: Management information system is centrally co-ordinated to ensure that its data processing, office automation, intelligence and decision support systems as well as other components, are developed and operated in a planned and co-ordinated way; to ensure that information is passed back and forth among the sub-systems as needed and to ensure that information system operates efficiently.

- (iii) *Sub-systems*: A MIS is composed of sub-systems or quasi separate component system that are the part of the overall - unified system. Each of these systems shares the goals of the management information system and of the organization. Some of the systems serve just one activity or level in the organization, while others serve multi-levels or multiple activities. The overall structure of the multiple systems should be carefully established as a part of long range system planning.
- (iv) *Integration*: A MIS is rationally integrated. Integration is significant so as to produce more meaningful MIS. Sub-systems are integrated so that the activities of each are inter-related with those of the others. This integration is accomplished primarily by passing data between these systems. Computer programmes and files can be designed to facilitate data flows among the systems, and manual procedures are also used to accomplish this integration. While integration makes information processing more efficient by reducing both intermediate processing and the incidence of independent generation of the same data by multiple departments, an even more important benefit is that it provides more timely, complete and relevant information. Senior managers particularly, benefit from integrated systems because they need cross functional information. Although total information of sub-systems is neither achievable nor desirable, a substantial degree of integration is required for an effective management information system.
- (v) *Transformation of Data into Information*: A MIS transforms data into information in variety of ways. When data is processed and is useful to a particular manager for a particular purpose, it becomes information. There are many different ways in which data must be transformed within an information system. For example, cost data for a particular organization may be summarized on a full-cost, variable-cost, and standard-cost basis for each organization unit, as well as by each cost type, customer type, and product line. The numerous ways in which MIS should transform data into information are determined by the characteristics of the organizational personnel and the characteristics of the task for which information is needed.
- (vi) *Enhance Productivity*: A MIS enhances productivity in several ways. It enables routine tasks such as document preparation to be carried out more efficiently, it provides higher levels of service to external organizations and individuals, it supplies the organization with early warnings about internal problems and external threats, it gives early notice of opportunities, it facilitates the organization's normal management processes and it enhances managers' ability to deal with unanticipated problems.
- (vii) *Conforms with Managers' Styles and Characteristics*: A management information system is developed in recognition of the unique managerial styles and behavioral patterns of the personnel who will use it, as well as the contributions made by managers. At the organization's more senior levels, the management information system is likely to be carefully tailored to each individual manager's personal tastes; it will be retailored to each new senior manager who takes over. At the organization's lowest levels, the management information system is more likely to be tailored to the unusual

way in which clerical and operations personnel use information and interact with the information system.

For middle managers, the information system is tailored to the general characteristics of managers. For professional and technical personnel, the information system is tailored to the nature of the specialized task, but with attention also given to the way the minds of these specialists process information.

- (viii) *Relevant Information:* A MIS should provide only relevant information. Determining what information is relevant may be difficult in situations in which analyses vary for different managers or according to particular circumstances, such as in the case of special problems. Systems designers must carefully consider the human factor when developing a management information system. Otherwise, the resulting system will be ineffective and probably will be discarded by its users.
- (ix) *Uses Established Quality Criteria:* A management information system must be designed to the required tolerance for timeliness, relevance, and accuracy of information. These tolerances vary from task to task and from level to level within an organization.
- (x) *Feedback:* A management information system should provide feedback about its own efficiency and effectiveness. The reporting of computer malfunctioning and transactions processing error rates is a simple example of this feedback. Statistics prepared by the system about who uses each system facility and how much they use each one are more sophisticated forms of feedback. Computer programs can record and report how much computer time is used by each user, how many pages are printed for each user, and how much internal data file space is utilized by each user's data, as examples; these and other usage statistics can be used for managerial analysis or as basis for charging each user for computer usage if desired.
- (xi) *Flexibility:* It must be designed to be easily modified if, for example, different information is needed because the environment changes or if the organization undertakes new activities (such as introducing new products) which require new modes of processing. The information system should be capable of being easily expanded to accommodate growth or new types of processing activities and also easily contracted.
- (xii) *Modularity:* The MIS should be composed of many modules or sub-systems rather than be designed as one and only one for a few large systems.
- (xiii) *Selective Sharing of Data:* Another desirable quality of an MIS is selective sharing of data. Two or more managers often need to utilize the same information; the system should have features, which allow ready access to information by multiple managers. An advanced feature that promotes this sharing is data bases.

On the other hand, it is often important to reserve certain information for the exclusive use of only selected managers. Sometimes, this need extends down to the record or field level, in which case some parts of a record are available to all managers, but only certain managers are permitted to examine

other parts. For example, an employee's current address or marital status may be needed by employee or other personnel, but access to information about pay rate, hours worked, gross pay, and other details of payments may be restricted to certain payroll managers. This selective sharing quality can be established by controls that are part of the computer programs.

- (xiv) *Computerized*: It is possible to have a MIS without using a computer. But its use increases the effectiveness of the system. In fact, its use equip the system to handle necessary attributes of the computer to MIS, for example accuracy and consistency in processing data and reduction in staff. These needs in management information system makes the computer a prime requirement.

MISCONCEPTIONS OR MYTHS ABOUT MIS

Let us clarify some of the misconceptions or "myths" about MIS:

1. *The study of management information system is about the use of computers*: This statement is not true. MIS may or may not be computer based, computer is just a tool. Whether it should be used while installing a MIS depends largely on several factors, e.g., how critical is the response time required for getting an information; how big is the organisation, and how complex are the needs of the information processing.
2. *More data in reports means more information for managers*: This is a misapprehension. It is not the quantity of data, but its relevance, which is important to managers in the process of decision-making. Data provided in reports should meet information requirements of managers. It is the form of data and its manner of presentation which is of importance to business managers. Unorganized mass of data bring confusion.
3. *Accuracy in reporting is of vital importance*: The popular belief is that accuracy, in reporting should be of high order. At the operating level, it is true. Other examples, where accuracy is really important can be; the dispensing of medicine; the control of aircraft; the design of a bridge etc. Accuracy, however, is relevant but not an absolute ideal. Higher levels of accuracy involve higher cost. At higher decision levels, great accuracy may not be required. The degree of accuracy is closely related to the decision problem. Higher management is concerned with broad decisions in principle and objective. A fairly correct presentation of relevant data often is adequate for top management decision. For a decision, on a few project proposal top management is not interested in precise rupee terms of the project cost. A project cost estimated at a fairly correct figure is all what it wants.

STRUCTURE OF A MIS

Structure of a MIS can be described in the following three forms:

- Functional form
- MIS at Different Levels
- Comprehensive Structure of MIS (Synthesis of functional and 3-tier structure of MIS).

Functional form

Under this type of structure, MIS may be viewed as divided by functions in an organization such as marketing, production, purchasing, technical, finance and accounting. In other words, each of these functional areas has their own information system to cater to its need of information. These information systems within the organization are interfaced with each other to share the information.

MIS at different levels

The following three levels in an organization are important from the point of view of MIS:

- (i) Strategic information level.
- (ii) Tactical information level.
- (iii) Operational information level.

Strategic information level: This level is concerned with determining, maintaining and supplying information required by top level management. Top management requires information for formulating long-term objectives, strategies, major policies and programmes of the concern. It also requires information about external environment i.e. economic, product market and technological development. Information requirements of top management are met by strategic information tier by arranging information from internal and external sources.

Tactical information level: This level meets the information requirements of the middle level management. Middle level management requires information to elaborate, clarify and operationalise organizational goals. It also requires information to translate strategies and policies in terms of action programmes and norms of performance.

Another important function of tactical level is to supply information to strategic tier for the use of top management. This tier collects the required information from strategic and operational tier and thus serves as a bridge between strategic and operational tiers of information.

Operational information level: This level meets the information requirements of operational level management. Operational level requires information for implementing and regulating operational plans for the purpose of converting inputs into outputs. Also it supplies routine and other information to tactical tier in summarized form.

Comprehensive Structure of MIS

The structure of a MIS is known as comprehensive if it possesses the following characteristics:

- It should be closely directed by management.
- It should integrate various sub-systems of the management.
- It should avoid duplication and redundancy of data.
- It should make the dissemination of information an effective one.
- It should be capable of meeting the information requirement of managers at different functions.

Taking into consideration the above characteristics, the suitable structure of a comprehensive MIS may be a federation of information sub-systems for different functions, viz. production, material management, marketing, finance, engineering and personnel. Each sub-system of information system is suppose to provide information support to executives for operational control, management control and strategic planning.

The MIS structure can be described in terms of support for decision making, management activity, and organizational functions. These three approaches are synthesized into MIS structure.

MIS is nothing but a conceptual framework which allows one to describe an existing or planned information system. Physical structure defines the way of implementing the MIS.

(i) Conceptual Structure

It is defined as a federation of functional units, each of which are embedded with four major information processing components i.e., transaction processing, operational control information system support, managerial control information system support and strategic planning information system support. Each of the subsystem of the information system has some unique data files, which are used only by that subsystem. There are files that need to be accessed by more than one application and need to be available for general retrieval. These files are organized in the form of a database, which is managed by the database management system. A further amplification of the structure is the introduction of common software. In addition to application programs written especially for each subsystem, there are common applications, which serve multiple functions. Each subsystem has linkages to these common applications. Several models are available which can be used by many applications.

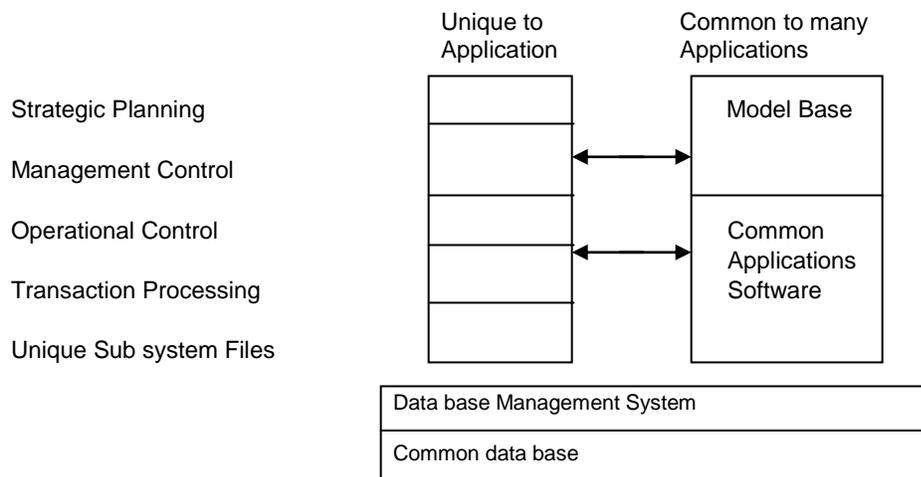


Fig. 7.1: The information system for a function such as marketing or finance

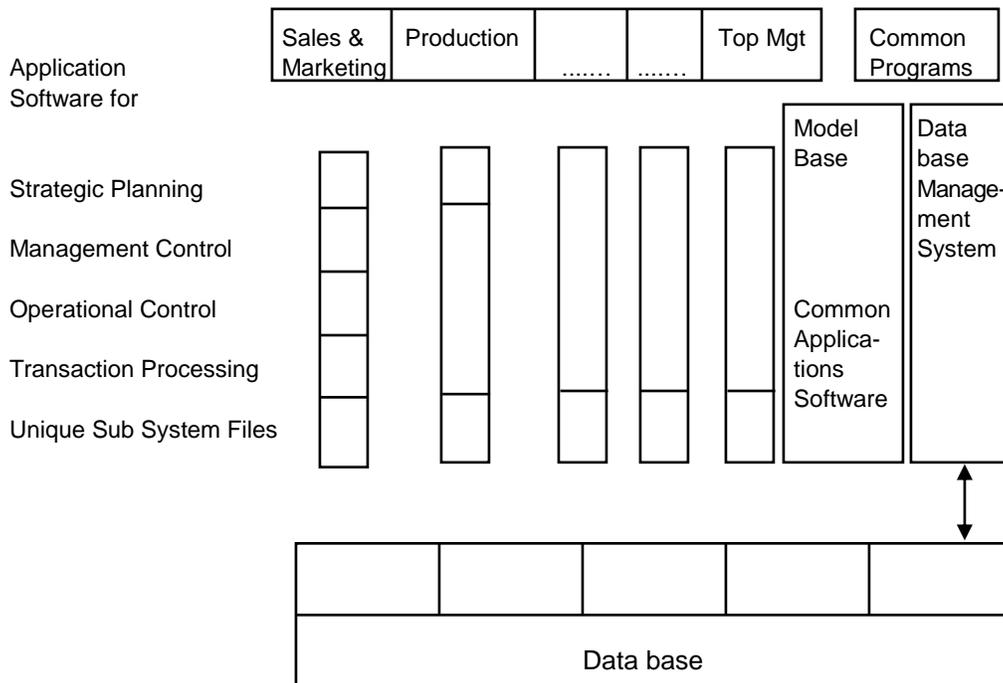


Fig. 7.2: MIS for the organisation

The structure of figure 7.1 has unique programs and files for its basic activities. It shares the use of common application software, a model base, a database, a database management system. The database management system controls all files in the common database, and may also be used for storage and retrieval of the files unique to a function. The combination of all subsystem forms the MIS for the organization. This is shown in fig 7.2. It can be seen that sales and marketing has four subsystems so is the case of production and other functional units in the organization. They all uses unique files and a common database. The unique files contain data of a specific functional unit.

The information requirement of executives for operational control, management control and strategic planning itself depends upon-operational function, level of management activity and type of decision-making.

Different operational functions have different information requirements. Their information requirements vary not only in content but in characteristics as well.

In fact, the content of information depends upon the activities to be performed under an operational function. Also an operational function influences the characteristics which a particular information must possess. For example, the information used for preparing employees payroll by the accounts department should be highly accurate.

The level of management activity too influences the characteristics of

information. For example, strategic planning requires more external information and information on the behavior of relevant and likely future events. Management control requires more accurate, precise, current and repetitive information. Operational level requires information in detailed form about the performance.

The content of information can be completely pre-specified in the case of programmed decisions. Whereas in the case of non-programmed decisions, it is difficult to specify complete information requirements.

The information or data requirements of each sub-system can be met by developing two types of data files, viz., unique and common. Unique data files may meet the specific information requirements of each operational function at different level of management activity for making programmed and non-programmed decisions. Common data file, stores data/information meant for general use in the decision-making process. The data stored in the data files is usually in the raw form and thus, requires processing. Processing of data may be performed by using softwares and decision models kept under model base. The use of data, in database may be controlled by Data Base Management System. The structure of a comprehensive MIS so evolved may be shown with the help of the diagram given at previous page.

(ii) Physical Structure

The physical structure of a MIS would be identical to the conceptual structure if all applications consisted of completely separate programs used by only one function, but this is frequently not the case. Substantial economies can be achieved from:

(a) Integrated Processing:

Integrated processing is achieved by designing several related applications as a single system in order to simplify the interconnections and reduce duplication of input. A good example is an order entry system. The recording of an order initiates a sequence of processing, each step using new data but also much of the data from processing. The major steps in a typical sequence are: (i) order entry, (ii) shipping invoicing, (iii) collection, and (iv) analysis. A large number of documents and reports are prepared from the initial entry of the order plus later entry of actual quantity shipped, freight, amounts received on account, and returns and allowances. The assumption is made that the customer name, address, and credit status, plus price of each item, are contained in customer files and billing files. The documents and reports from order entry are not associated with a single function but with the sales and marketing, logistics, and accounting and finance functions. In other words, an integrated order entry system crosses functional boundaries. Here, in this case, we have common modules and specific modules.

(b) Use of Common Modules:

Common modules make use of the common database which is specific for unique files. However, the modules can use both types of data at a time.

(iii) Issues of MIS Structure

One of the important issues regarding the structure of MIS is formal versus informal information systems.

The complete information processing system of an organization consists of both public systems and private systems. Individuals keep private systems. On the other hand, public systems are known to relevant persons in the organization and can be used by those who have authority to use. There are formal and informal systems within private and public systems. Documents and other records, usually indicating compliance's with pre-specified rules and procedures manifest the formal system. The informal systems may process information that is vital to organizational functioning but without formal records of that process.

(iv) Extent of Integration

Some advocates of "total systems" have argued for complete integration of all formal information processing. The experience to date suggests that such a tightly integrated system is impractical. There are too many factors to consider all at once, and maintenance is difficult. For this reason, information systems tend to have a modular design with integration only where required. Inconsistencies among subsystems are reduced by the use of standards and the common database.

COMPUTERIZED MIS

The notion Management Information System refers to the formal system installed in an organization for purposes of collecting, organizing, storing and processing data and presenting useful information to management at various levels. It serves as an aid to managerial functions of planning and control. Many medium sized and large enterprises find it convenient to computerize their MIS to make it automatic and highly organized. The advent of high-speed electronic computers has proved to be a boon to organizations for making their Management Information Systems very sophisticated and efficient by computerizing them. The very character and content of MIS have undergone significant changes as a result of computerization; so much so, MIS has almost come to mean computer based MIS. There are non-computer-based management information systems also.

The specific features of computer based MIS are outlined as follows:

- Organization and updating of huge mass of raw data of related and unrelated nature derived from internal and external sources at different period of time.
- Ability to process data into information with accuracy and high speed. It involves making complex computations, analysis, comparisons and summarization's. Though humans can do the processing, the computer's ability to process huge data is phenomenal, considering its speed, reliability and faithfulness in perfectly following the set of instructions.
- Super-human memory, tremendous volume of data and information and the set of instructions can be stored in the computer and can be retrieved as and when needed. Management can get any bit of stored information from the computer in a matter of seconds.
- The input data in the computer can be processed into a number of different outputs and for a variety of purposes. The system is so organized that managers at different levels and in different activity units are in a position to obtain information in whatever form they want, provided that relevant

“Programmes” or instructions have been designed for the purpose.

- The information processing and computer technology have been so advanced that managers are able to obtain real time information ongoing activities and events without any waiting period.
- Computer based MIS opens up new vistas for management to make efficient, timely decisions on vital operations of the enterprise and major strategic and tactical problems. It also helps organizations to gain substantial economies by reduction of clerical and computational time.

BASIC REQUIREMENT OF COMPUTER BASED MIS

The basic requirements of a computer based MIS in an organization are listed as below:

1. *Hardware*: It refers to the physical computer equipment and associated devices. The hardware must provide five basic functions, i.e., input of data entry, output, secondary storage for data and programmes, central processor (computation, control, and primary storage) and communication.
2. *Software*: It is a broad term, it means the instructions or programs that direct the operation of the hardware. The software can be classified into two major types: System Software and Application Software.
3. *Database*: The database contains all data utilized by the application software. An included set of stored data which is often referred to as file. The physical existence of the stored data is known as database.
4. *Procedures*: Formal operating procedures are physical components because they exist in a physical form such as a manual or instruction booklet. Basically, three major types of procedure are required:
 - User Instructions (for users of the application to record data, employ a terminal to enter or retrieve data, or use the result).
 - Instructions for preparation of input by data preparation personnel.
 - Operating instructions for computer operations personnel.
5. *Operations Personnel*: It includes personnels such as computer operators, system analysts, programmers, data preparation personnel.

APPROACHES OF MIS DEVELOPMENT

For developing MIS in an organisation, the following three approaches are generally used.

Top down approach

The development of MIS under top down approach begins by defining the objectives of the organization, the kind of business it is in, and the constraints under which it operates. The activities or functions for which information would be required are also identified. The crucial strategic and tactical decisions are also defined and the decisions necessary to operate the activities are specified. From the activities or functions and the decisions to be made, the major information requirements are ascertained.

This approach develops a model of information flow in the organization, which acts as a guide for designing the information system. By using the model of information flow various information sub-systems may be defined. Each sub-system comprises of various modules. A module is a basic unit for information system's development. The selection of module for developing system is made on the basis of the priority assigned to them. The various sub-systems and their modules are coordinated to achieve the objective of integration. The information system so developed is viewed as a total system fully integrated rather than as a collection of loosely coordinated sub-systems.

As the name indicates, top management takes the initiative in formulating major objectives, policies and plans in a comprehensive manner and communicates them down the line to middle and supervisory management levels for translating them into action plan. This approach only concentrates on implementation and day-to-day control.

Bottom up Approach

The development of information system under this approach starts from the identification of life stream systems. Life stream systems are those systems, which are essential for the day-to-day business activities.

Examples of life stream systems include the following:

- ▶ *payroll,*
- ▶ *sales order,*
- ▶ *inventory control, and*
- ▶ *purchasing.*

The development of information system, for each life stream system starts after identifying their basic transactions, information file requirements and information processing programs.

After ascertaining the data/information requirements, files requirements and processing programs for each life stream system, the information system for each is developed. The next step is towards the integration of data kept in different data files of each information system. The data is integrated only after thoroughly examining various applications, files and records. The integrated data enhances the sharability of the database. It also ensures that uniform data is being used by all programs. Integrated data also provides added capability for inquiry processing and ad hoc requests for reports.

The next development under bottom up approach may be the addition of decision models and various planning models for supporting the planning activities involved in management control. Further, these models are integrated to evolve model base. The models in the model base facilitate and support higher management activities. They are useful for analyzing different factors, to understand difficult situations and to formulate alternative strategies and options to deal them.

A comparison of top down and bottom up approaches reveals the following points:

- Top management takes the main initiative in formulating major

objectives, strategies and policies, for developing MIS under top-down approach. In the bottom up approach, it is the supervisory management who identifies the life stream systems for which MIS may be developed.

- Middle and supervisory management levels have a little role in the development of system under top down approach. Under bottom up approach, management refrains from guiding the development of system developed by supervisory level.

The information system developed under top down approach is more consistent with the systems approach and is also viewed as a total system, which is fully integrated. The information system developed under bottom up approach is developed through an orderly process of transition, building upon transaction processing sub-system. This system may not be integrated.

Integrated Approach

If used objectively, it can overcome the limitations of the above two approaches. This approach permits managers at all levels to influence the design of the system. Top management will identify the structure and design of MIS suitable to the concerned department. The design is presented to the lower level management for their views and modification. The lower management is permitted to suggest changes, additions, or deletions and return the design with their suggestions to the top level for approval. The revised design is drawn and evaluated by the top level and sent down again in a modified form for further consideration if required. This is an iterative process. It continues until a final design is achieved, that satisfies the requirement at all levels in the organization.

PRE-REQUISITES OF AN EFFECTIVE MIS

The pre-requisites of an effective MIS are nothing but mainly its resources and management support. These are described in the following section :

(a) Qualified Systems and Management Personnel

One of the important pre-requisites of well-defined MIS is that qualified personnel's at all levels should man it. These experts should take into account views of their fellow employees. The personnel's of the MIS comprises of atleast two category of personnel viz.:

- (i) Systems, Communication, and Computer Experts;
- (ii) Management Experts.

Systems, communication and computer experts should also be capable of understanding management concepts to facilitate the understanding of problems faced by the concern. They should be well versed with the process of decision making and information requirements for planning and control functions. Management experts, on the other hand, should also understand clearly the concepts and operations of a computer. This basic knowledge of computer based systems will be useful to the management experts and will help them in understanding the problems of another category of experts. This will help the management in dealing with hiring suitable experts, recruiting fresh candidates and

developing them to meet the specific requirement of the organization. Top management in the organization should also take in to account the turn over of the experts in the field of MIS. In addition, there is a third category of the personnel's who are very important and they are the users of the system.

(b) Database

The word is now taking new name such as data warehouse, which is being used presently in large corporates. Database is consolidation of many files, which contain the data of the organization. The data in a database is organized in such a way that access to the data is improved and data redundancy is reduced. It also increases the data integrity.

The main feature of database is that all subsystems will utilize the same database kept in different files. The other important features of databases are:

- (i) *Avoiding uncontrolled data redundancy and inconsistency:* Application shares the data stored in a database, rather than owning private files that would often store redundant data. This reduces the storage costs; there is no need to update multiple copies of the same data. This prevents the possibility that inconsistent data will reside in multiple files.
- (ii) *Program-Data Independence:* When the database is managed by a DBMS, programs can be written independent of the actual physical layout of the data or even of the total logical structure of the data. DBMS knows these structures; it thus provides the mapping from a logical view of the data in a given application to the actual physical layout of the data on the storage device.
- (iii) *Flexible Access to shared data:* The database approach has opened data for access to users and applications. Query languages enable end users to access data directly. Applications can be written to use any data stored in corporate databases, rather than to rely only on specially created files.
- (iv) *Reliability:* The reliability of the stored data is ensured by the DBMS managed databases themselves, rather than by special programming. A variety of relationships between entities may be rather easily defined.
- (v) *Centralized Control of Data:* There are many advantage of centralized control of database: Few are listed in the following:
 - Global planning and evolution of the data resources are possible.
 - Security may be maintained by specifying the authorization for data access and modification to the uniform interface for all programs and users that is to the DBMS; these security measures may be employed to protect the privacy of individuals i.e. the stored data of the concern.
 - Integrity constraints may be imposed to further ensure the accuracy of data in the database.
 - Corporate wide standards can be enforced in naming and representing the data.

(c) Support of Top Management

For a MIS to be effective, it should receive full support of top management. The

basic reason for this is that the resources involved in computer based information system are large and growing larger and larger in view of the importance of technology in the present context. To get these resources for implementing the MIS, the support of top management is essential.

(d) Control and Maintenance of MIS

Control of the MIS means the operation of the system as it was designed to operate. Sometimes, users develop their own procedure or short cut methods to use the system, which reduces its effectiveness. To check such habits of users, the management at each level in the organization should devise methods for information control. Maintenance is closely related to control. During the maintenance systems management will discover needs for improvement in the system. However, formal methods of changing and documentation has to be identified by the management.

(e) Evaluation of MIS

An effective MIS should be capable of meeting the information needs of its executives in future as well. To maintain this capability evaluation of MIS and timely action thereof is required. The evaluation of MIS should take in to account the following:

- Flexibility in built, with the system to meet any expected and unexpected information requirement in future.
- Ascertaining the views of the users and the designers about the capabilities and deficiencies of the system.
- Guiding the appropriate authority about the steps to be taken to keep the effectiveness of MIS alive.

COMPUTER AND ITS EFFECT ON MIS

The effects of applying computer technology to information systems can be listed below:

(i) Increase in Speed of Processing and Retrieval of Data

Modern business situations, are characterized by, high degree complexity, keen competition and high risk and reward factors. This invariably calls for system capable of providing relevant information with minimum loss of time. Manual systems howsoever well organized often fail to match the demand for information for decision-making. Computer with its unbelievably fast computational capability and systematic storage of information with random access facility has emerged as an answer to the problems faced by management. Processing of data in relevant form and design and retrieval of it, when needed, in fact requires considerably less time and facilitate the management action and decision-making. The speed of computer processing is in nano-range, i.e.; an operation takes only billionths of a second. This characteristic of computer has accounted for as a major factor in inducing MIS development. Computers today are capable of meeting varied type of information requirement of executives.

(ii) Expanded Scope of use of Information System

The importance and utility of information system in business organizations was

realized by most of the concerns, after the induction of computers for MIS development. System experts in business organizations develop areas and functions, where computerized MIS could be used to improve the working of concern. This type of applications hitherto, not feasible under the manual system. For example, it was made possible by using an on line real time system to provide information to various users sitting at a remote distance from a centrally located computer system.

(iii) Widened Scope of Analysis

The use of computer can provide multiple type of information accurately and in no time to decision -makers. Such information equips an executive to carry out a thorough analysis of the problem and to arrive at the final decision. Computers are capable of providing various types of sales reports for example, area wise sales; commission of each sales man; product wise sales etc. These reports are quite useful in analyzing the sales department working and to ascertain their weaknesses, so that adequate measures may be taken in time. In this way, the use of computer has widened the scope of analysis.

(iv) Complexity of System Design and Operation

The need for highly processed and sophisticated information based on multitudes of variables has made the designing of system quite complex. During the initial years, after the induction of computer for MIS development, systems experts faced problems in designing systems and their operations. The reason at that time was the non-availability of experts required for the purpose. But these days the situation is better. The manufacturers have developed some important programs (software) to help their users. Some private agencies too are there who can perform the task of developing programs, to cater the specialized needs of their customers, either on consultancy basis or on contract.

(v) Integrates the Working of Different Information Sub-systems

A suitable structure of management information system may be a federation of information sub-system, viz., production, material, marketing, finance, engineering and personnel. Each of these sub-systems is required to provide information to support operational control, management control and strategic planning. Such information may be made available by common database. This common database may meet out the information requirements of different information sub-system by utilizing the services of computers for storing, processing, analyzing and providing such information as and when required. In this way, computer technology is useful for integrating the day-to-day working of different information sub-systems.

(vi) Increased the Effectiveness of Information Systems

Information received in time is of immense value and importance to a concern. Prior to the use of computer technology for information purposes, it was difficult to provide the relevant information to business executives in time even after incurring huge expenses. The use of computer technology has overcome this problem. Now, it is quite easy to provide timely, accurate and desired information for the purpose of decision-making. Hence, we can conclude, that the use of computer has increased the effectiveness of information system also.

(vii) More Comprehensive Information

The use of computer for MIS, enabled system experts to provide more comprehensive information to executives on business matters.

IMPACT OF COMPUTERS AND MIS ON CORPORATE MANAGEMENT

Top level corporate management spends most of its time on business planning. The major responsibilities of this level include long and short-range planning, resource and capacity analysis, setting of profit and budget goals, and in general establishing the business objectives of the company. It is, thus, apparent that there is a heavy planning and lesser control element in the work domain of top level management.

Presently, the impact of computers and MIS on the working of this level is minimum. The reasons for lesser computer effect on top level are:

- (i) unstructured nature of data;
- (ii) slow acceptance and use of operations research techniques;
- (iii) non-availability of suitable systems and computer experts;
- (iv) reliance on intuitive abilities.

The impact of MIS on top level too is far less than at the middle or supervisory level. This fact is apparent from the following table, which has been constructed on the basis of several surveys.

	<i>Decision Making Process</i>	<i>Job Contents</i>	<i>Job Members</i>
Top Management	Scant Influence	Scant Change	No Influence
Middle Management	Moderate Influence	Moderate Change	Scant Influence
Lower or Supervisory level	Major Influence	Major Change	Moderate Influence

In fact, MIS in its present form is more effective for control than for planning. Therefore, it can be concluded that the impact of MIS on top management level is almost non-existent.

The potential impact of computers on top level management may be quite significant. An important factor, which may account for this change is the fast development in the area of computer science. It is believed that in future, computers would be able to provide simulation models to assist top management in planning their work activities. For example, with the help of a computer it may be possible in future to develop a financial model by using simulation techniques, which will facilitate executives to test the impact of ideas and strategies formulated on future

profitability and in determining the needs for funds and physical resources. By carrying sensitivity analysis with the support of computers, it may be possible to study and measure the effect of variation of individual factor to determine the final results. Also the availability of a new class of experts will facilitates effective communication with computers. Such experts may also play a useful role in the development and processing of models. In brief, potential impact of computers would be more in the area of planning and decision-making.

Futurists believe that in future top management will realize the significance of techniques like simulation, sensitivity analysis and management science. The application of these techniques to business problems with the help of computers would generate accurate, reliable, timely and comprehensive information to top management. Such information will be quite useful for the purpose of managerial planning and decision-making. Computerized MIS will also influence the development, evaluation & implementation of a solution to a problem under decision-making process.

The impact of computers and MIS on middle level management is moderate. This level of management translates the management objectives into plans, arranges resources to achieve such objectives and goals as laid down by top management. Also it reviews the result of operations performed at the supervisory level. It, thus, acts as a bridge between the other two levels. The information provided by computer serves only limited purpose to middle level management. Such information is quite effective for carrying out an analysis of the operations but has little impact on the formulation of organizational plans.

Potential impact of computers and MIS on middle management level will be significant. It will bring a marked change in the process of decision-making. At this level, most of the decisions will be programmed and thus will be made by the computer, thereby drastically reducing the number of middle level manager's requirement.

Illustration:

In the case of inventory control system, computer will carry records of all items with respect of their purchase, issue and balance. The reorder level, reorder quantity etc., for each item of material will also be stored in computer after its pre-determination. Under such a system as soon as the consumption level of a particular item of material will touch reorder level, computer will inform for its purchase immediately. The futurists also foresee the computer and the erosion of middle management as the vehicles for a major shift to decentralization. The new information technology will enable management to view an operation as a single entity whose effectiveness can only be optimized by making decisions that take into account the entity and not the individual parts.

The impact of computers and MIS today at supervisory management level is maximum. At this level, managers are responsible for routine, day to day decision and activities of the organization, which do not require much judgement and discretion. In a way, supervisory mangers job is directed more towards control function, which are highly receptive to computerization. For control, such mangers

are provided with accurate, timely, comprehensive and suitable reports. A higher percentage of information requirements of executives are met out at this level.

Potential impact of computers and MIS on supervisory level will completely revolutionize the working at this level. Most of the controls in future will be operated with the help of computers. Even the need of supervisory managers for controlling the operation/activities now performed manually will be either fully or partially automated.

In future MIS would provide highly accurate, precise and desired information to control operations with the support of computers.

CONSTRAINTS IN OPERATING A MIS

Major constraints which come in the way of operating an information system are the following:

1. Non-availability of experts, who can diagnose fully the objectives of the organisation and give a desired direction needed for operating information system.
2. Difficulty usually faced by experts, in selecting the sub-systems of MIS, to be designed and operated upon first.
3. Source of availability of experts for running MIS effectively, is not always known to management.
4. Due to varied objectives of business concerns, the approach adopted by experts for designing and implementing MIS is non-standardised one.
5. Non-availability of co-operation from staff.
6. Non-availability of heavy financial resources required for running the MIS effectively.
7. Turnover of experts is quite high.
8. It is difficult to quantify the benefits of MIS, so that it can be easily comparable with cost.
9. Perceptual problems as its utility is not readily perceptible by many users.

LIMITATIONS OF MIS

The main limitations of MIS are as follows:

- (i) The quality of the outputs of MIS is basically governed by the quality of inputs and processes.
- (ii) MIS is not a substitute for effective management. It means that it cannot replace managerial judgement in making decisions in different functional areas. It is merely an important tool in the hands of executives for decision-making and problem solving.
- (iii) MIS may not have requisite flexibility to quickly update itself with the changing needs of time, especially in the fast changing and complex environment.

- (iv) MIS cannot provide tailor made information packages suitable for the purpose of every type of decisions made by executives.
- (v) MIS takes into account mainly quantitative factors; thus it ignores non-quantitative factors like morale, attitudes of members of the organization, which have an important bearing on decision-making process of executives.
- (vi) MIS is less useful for making non-programmed decision-making. Such type of decisions are not of routine type and thus they requires information, which may not be available from existing MIS to executives.
- (vii) The effectiveness of MIS is reduced in the organization, where the culture of hoarding information and not sharing with others hold.
- (viii) MIS effectiveness decreases due to frequent changes in top management organizational structure and operational team.

MIS AND DATA PROCESSING

A data processing system processes transactions and produces reports. It represents the automation of fundamental, routine processing to support operations. Prior to computers, data processing was performed manually or with simple machines. A management information system is more comprehensive; it encompasses processing in support of a wider range of organizational functions and management processes. However, every MIS will also include transaction processing as one of its functions.

What does it takes into account to make a data processing system into a management information system? Can a rather mundane data processing system be a MIS if a simple database, retrieval capabilities, and one or two decision models are added? This is not a useful question. MIS is a concept and an orientation towards which an information system design moves rather than an absolute state. Therefore, the significant issue is the extent to which an information system adopts the MIS orientation and supports the management functions of an organization. The answer is usually a matter of degree rather than a simple yes or no.

One important aspect of the difference between MIS and routine data processing is the capability to provide analysis, planning, and decision making support. An MIS orientation means users have access to decision models and methods for querying the database on an ad hoc basis; the database is also, of course, an essential part of routing transaction processing and reporting. Furthermore, a MIS orientation means information resources are utilized so as to improve decision-making and achieve improved organizational effectiveness. Information resources are also used as a means of achieving a competitive advantage.

MIS AND DECISION SUPPORT SYSTEMS (DSS)

A computer system that combines data, analytical tools, user-friendly software to support decision-making at the management level is called decision support system.

DSS (Decision Support System) are more targeted than MIS system. Comment?

Yes, DSS are more targeted than MIS system. MIS systems provide managers with routine flow of data and assist in the general control of the organization. In contrast, DSS are slightly focused on a specific decision of classes of decision such as routing, querying, on three basic parameters which are given below:

- *Philosophy: DSS provides integrated analytical tools, data, model base (a collection of mathematical and analytical models), and a interface to the user in the form of a user friendly software. MIS provides structured information to the end-users at all level in an organization.*
- *System Analysis: DSS establish what tools are used to incorporate the decision making process of an organization. Whereas MIS identify information requirements at different levels in the organization.*
- *Design: The design of DSS is based on iterative process and keep on changing with every feedback of the user. On the other hand, MIS deliver a system based on frozen requirements.*



CORE CAPABILITIES OF DSS

A decision support system (DSS) is an information system application which assists decision-making. DSS tends to be used in planning, analyzing alternatives, and trial and error search for solutions.

A DSS is required to possess the following core capabilities:

- (i) *Representations:* It includes the presentation of the information in the form of graphs, charts, lists, reports, formatted reports, symbols, etc. These results are being used for control mechanism.
- (ii) *Operations:* It includes logical and mathematical manipulation of data. These operations are confined to gathering information, generating statistics, preparing reports, assigning risk and values, generating alternatives using simulation etc.
- (iii) *Memory aids:* It also provides updating of databases and memory, viewing of data, work spaces, libraries and linkages among libraries and work places.
- (iv) *Control aids:* It provides the facility to user to control the activity of DSS. It include a language permitting user control of operations, representations and memory. It also include features such as tutorials, help commands, functions keys, conventions etc.

DSS are generally operated through terminal-based interactive dialogs with users. They incorporate a variety of decision models.

On the other hand, MIS converts TPS data into information for monitoring

performance and managing an organization. Important points of comparison of MIS and Decision Support System are given in the following table :

	Management Information System (MIS)	Decision Support System (DSS)
1.	Information form of a MIS is periodic, and based on demands.	Information form of DSS is interactive.
2.	Information formats are pre-specified and fixed.	DSS information formats are adhoc, flexible and adaptable.
3.	Information is provided by extraction and manipulation of operational data.	Information is produced by analytical modeling of operational and external data.
4.	It provide information about the performance of the organization.	It provides information and decision support technique to confront specific problems or opportunities.
5.	It supports the intelligence and implementation stages of decision making.	It supports the intelligence decision, choice and implementation stages of decision making.
6.	It supports structured decisions for operational and tactical planning and control.	It supports the semi-structured and unstructured decisions for technical and strategic planning and control.
7.	It provides indirect support designed to many managers.	It provides direct support tailored to the decision making styles of individual managers.

MIS AND INFORMATION RESOURCE MANAGEMENT

Information resource management (IRM) is an approach to management based on the concept that information is an organizational resource. Given that view, the task of information system executive is to manage the resource. The resource is defined very broadly. The scope of IRM includes data communications, word processing, and personal computers as well as traditional data processing. The IRM concept tends to emphasize the organizational effectiveness of the information system resource rather than the technical sophistication or efficiency of the hardware and software. The IRM concept is applicable to management of the MIS function.

EXECUTIVE INFORMATION AND DECISION SUPPORT SYSTEMS

Executive Information Systems (EIS) provides executives information in a readily accessible interactive format. It is a computer based system that accesses data concerning critical success factors of an organization and allow high level executives to display this information on demand. They are also known as executive support systems. The characteristics of a good executive information system are as follows:

- Simple use interfaces are crucial. Good systems provide a wide variety of user interfaces such as a mouse, a touch screen, or a keyboard and allows the executive to choose which ever he or she is comfortable with.
- An EIS should be secure because the data that is contained and (or accessed by an EIS is obviously important and often proprietary information.
- An EIS should support what-if-analysis and adhoc queries.

- An EIS should have the capability of allowing the executives to drill down into the data.
- Very quick response time is necessary.
- Colour graphics capabilities are important for displaying the information.
- The data used in an executive information system may reside in many different locations, efficient network is essential for expert systems.

The comparison of the Executive Information System and Decision Support System is given in the following table:

	<i>Executive Information System</i>	<i>Decision Support System</i>
1.	It directly supports the value added work in the organization. It is relevant for top management.	It provides information, models or tools for decision making.
2.	Its users are the people who do value added work which requires special skills.	Its users are analysts, managers and other professionals.
3.	It can support communication or information sharing between people doing different parts of the task. It may help in explaining the result of the task to customers. It cut across functional areas. EIS derives data from different functional areas but the decisions that are made by integrating these data are not meant for any specific functional area but for the organization as a whole.	Result of analysis using DSS provide a clear rationale for explaining a decision.
4.	It provides tools, information, or structured methods for making decisions. Most of the time, EIS is in the forms of summary reports and graphics. EIS combines both internal and external information.	It provides tools for analysing data and building models and helps in analysing the alternatives.
5.	Examples of EIS are (i) system to generate competitive bids (ii) system to diagnose machine failures (iii) system to support loan approval process.	The examples of DSS are (i) system help insurance people to test alternatives (ii) system displaying the current priorities of machine operative (iii) system analyzing characteristics of customers who pay bills promptly.
6.	Its common features are (i) user friendly interface (ii) user friendly methods of analyzing data.	Its common features are (i) user controlled interaction with computers (ii) use of models and data (iii) information systems are applied to semi-structured tasks.

ARTIFICIAL INTELLIGENCE AND EXPERT SYSTEMS

Artificial Intelligence: The effort to develop computer based systems which can

behave like humans, with the ability to learn languages, accomplish physical tasks, use a perceptual apparatus, and emulate human expertise and decision making. An example of such an effort is the diagnosis of a specific illness and prescription of a course of treatment by a physician. These are artificial intelligence programs called expert systems that will perform limited diagnosis of an illness with an accuracy rate greater than the physician. The primary areas of artificial intelligence research and applications today are robotics, computer vision, speech recognition, natural language processing, expert systems, and neural networks.

Expert Systems: It is a knowledge intensive computer program which captures the expertise of a human in a limited domain of knowledge and experience. It helps in organization's value added work. The users of an expert system are the people who do value added work which requires a special skill or expertise. It provides tools, information, structured methods for decision making. It stores and provide expert knowledge to support decisions in specific areas.

Examples of expert system:

- ▶ System which generate competitive bids.
- ▶ System to help sales people and suggest the best choice for the customer.
- ▶ System which helps in diagnose of failures may be machine or human being.
- ▶ Systems to support a loan approval system.
- ▶ Systems to support training in specialized areas where experts are in scarcity.
- ▶ System to find price inconsistencies between different equity markets.

The components of an expert system include a knowledge base and software modules that perform inferences on the knowledge and communicate answers to a user questions.

Some of the important advantages and limitations of an Expert System in an organization include the following:

Advantages of Expert System	Limitations of Expert system:
<p>It provides more than one alternatives for the considerations of executives for making decisions.</p> <p>It provides more logical and rational justifications for decision making since it acts like an expert in the concerned areas.</p> <p>It makes available consistent decisions because it is based on rules than on personal whims and prejudices.</p> <p>It saves the user's time.</p>	<p>Expert systems are sometimes overrated.</p> <p>Expert systems can be expensive to develop and maintain.</p> <p>It is difficult to elicit the knowledge of experts.</p> <p>It lacks common sense.</p> <p>Expert system cannot learn.</p> <p>The validation of expert systems can be difficult.</p> <p>It is limited to certain problems and unsuitable to complex managerial problems.</p> <p>It is a costly exercise in terms of time and resources.</p>

ENTRUSTING MIS IN A CORPORATE ENTERPRISE

The MIS in a corporate enterprise is usually entrusted to an officer who is designated as Chief of Management Information Department and reports to Chief Executive of the concern. To suggest who should succeed in this position in the corporate enterprise requires a thorough analysis of present state of MIS. The MIS presently may be in anyone of the following form:

- (a) It may be manual one.
- (b) It may be computerized one.
- (c) It may be a manual one but is heading for computerization.

Under a manual management information system in a corporate enterprise, the tasks of procuring, refining, analyzing, storing and retrieval of data /information are carried out by manual means. To carry out these functions, a set of suitably designed form is used. Each form of this set is used for a specific function.

To specify who has to collect a specific information, the necessary form to be used the frequency of collecting the information and a manual known as MIS manual provides all such related matters guidelines. Such a system of information may be entrusted to a person who possesses the experience of working with several functional areas. Such a person may be either from finance or marketing department. This choice is suitable due to following reasons.

- The person entrusted with MIS knows quite clearly on the basis of his experience and interaction with other departments, the type of decisions made by different executives.
- He can also ascertain the information requirement of executives from his knowledge and experience gained, while working closely with different functional areas.
- He can also perceive the frequency and the changing needs of information requirement of executives.
- His familiarity with the behavior and ways of working of his colleagues also helps him in performing his task well.

In the case of computerized management information system, the information is collected manually and is transferred to a computer system for analysis, storage and retrieval. Such type of information system may be entrusted to a computer and system expert, who is well conversant with management concepts and the working of business executives. This choice of entrusting MIS is supported by these reasons.

- (i) The head of management information system possesses the requisite capabilities, which are necessary for developing various applications & guiding the smooth running of system.
- (ii) He can also foresee the changing information requirements of executives by analyzing the decisions made and the problems, which may be faced in future.

Lastly, the system, which involves the computerization of the present manual - system may be entrusted to a project leader. This project leader may not directly carryout the task of converting the system but may render all possible help to the

outside consultants. The help of outside consultants may be sought till the project leader gains the necessary confidence to run it independently.

The main reasons for this choice are the following:

- (i) Due to lack of project leaders in the area of computers, he may be assisted by outside consultants, till the development of the system is complete and he gains necessary confidence of handling the system independently.
- (ii) Since the project leader works closely with outside consultants, so he understands the system quite thoroughly than anyone else.

MIS IN INDIAN ORGANIZATIONS

Although the significance of and need for MIS have been well realized in developed countries like U.S.A., it has not yet been so in countries like India. The rapid advancement of technology and the consequent advent of computers have mainly contributed to the success of MIS in those developed countries. In India, where computers were not heard earlier to 1950s, the big organizations, their financial capacities could not take a clue from their counterparts in those advanced countries and hence lagged behind. Even after three decades of computer advent in India and operations of MIS in certain big organizations, it still has remained a moot point whether it would serve any useful purpose and its installation justified.

It is, however, fallacious to seek any alibi for the present unsatisfactory and unfruitful results of MIS in the Indian organizations.

That the Indian organizations lag behind in the computer technology which is, no doubt essential for the development of MIS, does no longer hold water as an excuse for its inadequate application and operation after four decades of computer introduction.

The major hurdle is the reluctance on the part of industrialists to convince themselves of the usefulness of MIS. It is because of their traditional thinking they do not extend a wholehearted cooperation and unstinted support to the implementation of MIS, without which any effort in this direction would prove futile. As a result, where MIS has been introduced, it has received only a lukewarm support and has not passed the take off stage. Another important reason for the unsatisfactory functioning of MIS in many Indian organizations is the lack of proper training on the part of the personnel dealing with it. Ineffective handling of the system by these inexperienced people has been mainly responsible for the tardy development of MIS in India. Another constraint is that India being a poor country, many business organizations cannot afford to invest huge funds required for the installations of MIS.

Even though the various problems put forth above are responsible for the slow growth of MIS, they are not altogether insurmountable. It should be realized that MIS, can be developed in a phased manner without facing any financial burden and the resultant benefits would be more than the expenses in operating the system by exposing them to different training programs designed for purpose. If MIS, is taken up with all the necessary sincerity and confidence, it would deliver the goods expected of it by the Indian organizations also. The efforts made for its development in these organizations would definitely bear fruits.

ENTERPRISE RESOURCE PLANNING (ERP) SYSTEMS

ERP Systems - Origin and Evolution

The concept of unifying enterprise wide information management systems and the robust technologies which make it happen may no longer be new to the world of business. ERP has its root in well established Material Requirement Planning (MRP) systems that have evolved over the last quarter of century. As data from the factory floor, warehouse or distribution center began to impact more areas of the company, the need to disseminate this data across the entire enterprise demanded that other business areas interoperate with the MRP system. Suddenly, MRP systems had responsibilities they could not fulfill, which lead to the development of MRP II systems, which have now given way to ERP.

ERP systems have stirred a lot of well-deserved buzz in a lot of different sectors of business. Companies like Baan, JBA, JD Edwards Oracle, PeopleSoft, QAD, SAP, SSA, Symix which are providing ERP solutions and are enjoying the reward of dramatic growth as manufacturers move away from legacy MRP II systems and begin the process of ERP implementation. The solutions they deliver are more robust than any host-based MRP system yet.

ERP – Meaning and Philosophy



Enterprise Resource Planning (ERP) system is actually a process or approach which attempts to consolidate all of a company's departments and functions into a single computer system that services each department's specific needs. It is, in a sense, a convergence of people, hardware and software into an efficient production, service and delivery system which generates profit for the company.

While the idea is easy to grasp in theory, the reality has been different. Most companies have a conglomeration of different systems and procedures (as well as hardware and software) designed 'specifically' for their own needs. Employee records (including payroll, medical and other benefits) are held by Human Resources. Financial data and processing, which includes payroll computations and employee compensations as well as invoicing and billing for company products and services, are held by the Finance Department. Production data is held by manufacturing. Inventories are held by warehousing. Customer orders are held by customer relations, and so on. The 'dream' of ERP is to have a single software solution integrating the different functions and activities into a seamless whole where information needed for decision-making is shared across departments, and the action taken by one department results in the appropriate follow-up action down the line.

The most often cited example of an ERP software is customer ordering and delivery where a customer's order moves smoothly from Sales, where the 'deal' is consummated, to Inventory and Warehousing, which retrieves and packages and order for delivery, to Finance where invoicing, billing and payments are handled, and on to Manufacturing, where replacement of the bought-and-paid-for product is done.

ERP, the enterprise wide system encompasses corporate mission, attitudes, beliefs, values, objectives, style of operation and of course people who make the organization. ERP system, thus, integrates all the processes of the organization with customer satisfaction and plans the management of resources of an enterprise. These solution help in focusing on production capabilities, managing logistics, and working out financial consequences of each decision rather than computing costs.

The basic philosophy of ERP system is that business process are to be integrated at all levels, treating all the resources of the enterprise as common resources primarily meant to cater to the changing needs of customers. Recognizing that customer needs keep changing, ERP system offers adaptability to the changing needs at an improved speed of response.

CHARACTERISTICS OF ERP

An ERP system is an organization broadly possesses the following characteristics:

- *Flexibility*: An ERP system should be flexible to respond to the changing needs of an enterprise. The client / server technology enables ERP to run across various database back ends through open data base connectivity (ODBC).
- *Modular and Open System Architecture*: ERP system should have open system architecture. This means that any module can be interfaced or detached whenever required without affecting the other modules. It should support multiple hardware platforms for the companies having heterogeneous collection of systems. It must support some third party add-ons also.
- *Comprehensive*: It should be able to support variety of organizational functions and must be suitable for a wide range of business organizations.
- *Beyond the Company*: It should not be confined to the organizational boundaries, rather support the on-line connectivity to the other business entities of the organization.
- *Best Business Practices*: It must have a collection of the best business process applicable worldwide.
- *Simulation of Reality*: Last but not the least, it must simulate the reality of business processes on the computers. In no way, it should have the control beyond the business processes and it must be able to assign accountabilities to the users controlling the system.

FUNCTIONS OF ERP

ERP is a business management system which combines all the aspects of the business. It takes care of all activities in the organization, including planning, manufacturing, sales and marketing. ERP could gain much attention in a very short span of time and many software applications sprang up to help business managers to implement ERP.

Typically, an ERP system uses a relational database system or it is integrated with it. ERP, the broad set of activities supported by multi-module application

software, helps the businessman to manage the important parts of his business which includes product planning, purchasing of the parts, maintaining inventories, interacting with suppliers, providing customer service and tracking orders in addition to many others. A highlight of the ERP system is that the data is made available to every participant in the process.

BENEFITS OF ERP SYSTEMS

Some of the important benefits of ERP systems to an organization in a complex, competitive, global and dynamic environment include the following:

- A single system to support rather than several small and different systems;
- A single applications architecture with limited interfaces;
- Access to management information unavailable across a mix of applications;
- Access to best practice systems and procedures;
- More integration hence lower costs;
- More "automation" of tasks generic costs and impacts.

In addition to above, ERP benefit is found at the technical level of the data systems also. Maintenance of different databases means that the same datum may appear in different places, and may even be of different values. This situation may occur when the datum is fed into different software and under other circumstances. The different values may result from mistakes or different interpretations of the same datum. The duration of an action, for example, may be defined in one place as about 10.14 seconds, and in another place it will be rounded of to 10 seconds. The calculations of the averages may be different in different software, according to different definitions of the data and extent of weight which result from the calculations. The unification of the databases enables a quicker and more reliable updating. The system also forces the organization to decide who will be in charge of introducing the data and the parameters of all software.

ERP systems are relatively new, hence more efficient than other older systems. The intensified technical capability also enables them to manage a larger quantity of data and to perform more sophisticated data processing. In view of the rapid development of the markets and the increase in the number of the products and the various raw materials, the new system promises durability when facing a significant increase in the level of the activity in the company. The primary advantage of the transition to ERP system lies, then, in the comfort, velocity, in the capability to deal with enormous quantities of data and of course, in the credibility of the modern as compared to the old.

However, ERP systems enable us to get much more technical improvement, as important as it may be. In investing a lot of thought, it is possible to get a substantial benefit in the way the organization is managed. The ERP is a comprehensive system, hence presenting opportunities to check and change the central processes of the organization. Being an integrated system, ERP also presents every manager with information about interfaces among the different functions, which might be influenced by his decisions. This way, it is possible to reach better business deals.

MANAGERIAL ASPECT OF ERP

Many applications of the ERP systems do not take into account the managerial aspect. Without managerial thinking, the project will grow over and above the true needs of the organization. Because of the novelty of the new systems, there is always the temptation to increase the application and to add data and options which are hardly related, if related at all, to the future activity of the organization. This way the system keeps growing until it is out of control. The greatest disadvantage of the ERP is the multiple options it presents to the confused customer. Today's managerial understanding claims that superfluous options in the information system actually are a curse for the future. Empirical studies found out that superfluous information is like superfluous stock and causes similar damages. New managerial approaches did manage to increase a high awareness of the damages that excess stock may cause. However, the damage that superfluous options and unnecessary data in the system can cause, have still not penetrated the consciousness of many managers.

When faced by the pressure to change the existing systems with novel ERP systems, it seems as if it is possible to apply the information system first, and only later prepare managerial functions for the new era. Such an attitude may cause more damage than an unfocused project, which goes on beyond the original planning and ends with a huge, frightening system. ERP systems have a characteristic which endangers the separation of processes. Theoretically, ERP system enable great flexibility in the direction of the organizational processes and methods of data processing. Most of the novel systems enable "customizing" the information systems according to the managerial needs of the specific organization. This enormous flexibility creates the hope that after application, the system can be regulated again. The moment the ERP system starts working, it is almost impossible to make real alterations. In other words, the decisions about the functioning of the ERP system, will remain valid up to its being replaced by another more novel system. The enormous flexibility is just a bluff. It exists only at the beginning of the way, and there is no turning back.

The ERP software market is estimated in billions. The cost for the organizations which apply it, is much higher than the cost of the software. It is estimated that the cost of the software stands around 20% of the general cost of the application of the system in the organization. However, the investment in the transition to ERP systems is enormous.

CONCLUSION

An ERP system with a management with a high level of understanding can give the organization much more than strengthening of the existing process through a better availability of information and higher credibility. When faced by the availability of the information, the process can be redesigned. In the past the organization has been producing according to an assumed forecast, since the exact needs of the customers could not be guessed. In the new process, they can produce directly to order, and still honor the supply dates, as long as the production floor has sufficient capacity to respond swiftly. In certain cases, when it looks as if there could be a capacity problem, another decision could be made, one based on profound knowledge, combined with the relevant information, and producing a controlled

quantity for the stock, in order to survive the load height of the pressure. The purchasing processes will demand that the operating process be more efficient, hence availability of information.

With intelligent application of ERP, we can achieve far reaching business results. But the organization is required to do more than changing the information system, the processes must also change, especially the thinking of the managers, and even of the workers of the organization.

Thus, by becoming the integrated information solution across the entire organization, ERP systems allow companies to better understand their business. With ERP software, companies can standardize business processes and more easily enact best practices. By creating more efficient processes, companies can concentrate their efforts on serving their customers and maximizing profit

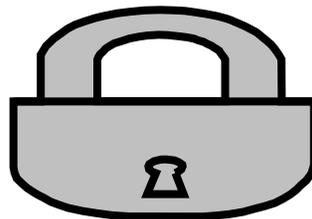
LESSON ROUND UP



- Executives in an organization provide leadership and direction for planning, organizing, staffing, supervising, and controlling business activities. Each of this business activity involves decision making process. For making decisions, executives need the information. A well-defined MIS provides information to all levels of management. The evolution of MIS is linked to the four major disciplines i.e. Management Accounting, Management Science/Operation Research, Management and Organization Theory and Computer Science.
- MIS is a system that helps management in the process of decision making. The three elements of MIS are Management, Information and System. It is necessary to understand these three components.
- Management information system is an integrated man/machine system for providing information to support the operations, management and decision-making functions in an organization.
- The structure of a MIS can be described in the forms i.e. Functional Form, MIS at Different Levels, and Comprehensive Structure of MIS (Synthesis of functional and 3-tier structure of MIS).
- The very character and content of MIS have undergone significant changes as a result of computerization; so much so, MIS has almost come to mean computer based MIS. The basic requirements of a computer based MIS include hardware, software, database, procedures and operations personnels.

- For developing MIS, three approaches i.e. Top Down, Bottom up and Integrated Approaches are used. An effective MIS should be capable of meeting the information needs of its executives in future as well. To maintain this capability, evaluation of MIS and timely action thereof is required.
- Computers have its effect on MIS and different levels of managements.
- A data processing system processes transactions and produces reports. It represents the automation of fundamental, routine processing to support operations. Prior to computers, data processing was performed manually or with simple machines.
- A computer system that combines data, analytical tools, user-friendly software to support decision-making at the management level is called decision support system.
- Information resource management (IRM) is an approach to management based on the concept that information is an organizational resource.
- Executive information system is a system which provides information to executives in a readily accessible interactive format.
- Artificial Intelligence refers to a computer based system that can behave like humans, with the ability to learn languages, accomplish physical tasks, use a perceptual apparatus, and emulate human expertise and decision making.
- Decision Support System is a computer system that combines data, analytical tools, user-friendly software to support decision-making at the management level.
- Expert system is a knowledge intensive computer program which captures the expertise of a human in a limited domain of knowledge and experience. It helps in organization's value added work. The users of an expert system are the people who do value added work which requires a special skill or expertise. It provides tools, information, structured methods for decision making. It stores and provide expert knowledge to support decisions in specific areas
- Enterprise Resource Planning or ERP system is actually a process or approach which attempts to consolidate all of a company's departments and functions into a single computer system that services each department's specific needs. It is, in a sense, a convergence of people, hardware and software into an efficient production, service and delivery system that creates profit for the company.

SELF TEST QUESTIONS

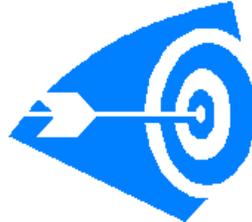


1. Define an MIS and discuss its objectives and characteristics.
2. What are the various approaches of MIS development in an organisation. Explain any two in detail.

3. Differentiate between MIS and Decision Support System.
 4. What is a Decision Support System?
 5. What is an executive information system and what are its characteristics?
 6. What is artificial intelligence?
 7. Discuss the information needs of various levels of management.
 8. State the pre-requisite of an effective MIS in an organisation.
 9. What is ERP? State its benefits and limitations for an organization.
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STUDY VIII
INTERNAL CONTROL SYSTEMS

LEARNING OBJECTIVES



The object of this study lesson is to enable students to:

- Understand the concept of internal control
- Classify the internal control
- Discuss the various elements of internal control
- Analyse the characteristics of effective internal control
- Describe the objective and scope of internal control
- Set out the limitations of internal control
- Understand the techniques of internal control, such as internal check, internal audit, flow charts, internal control, inter-firm and intra-firm comparisons, etc.

INTRODUCTION

It is the statutory duty of the directors of a company to safeguard its assets. They are supposed to achieve the objectives efficiently, effectively and in an orderly manner. Further, it is their responsibility to see that the records are accurate and reliable. They shall, therefore like to ensure that the policies laid down by them for the purpose are adhered to. For a timely corrective decision they must be kept informed. With a rapid increase in the operations of an entity and complexity of the nature of transactions the manager of an organisation may find it difficult to control all the operations by his direct and close supervision. In such a situation, the management needs to devise a system, which with its efficient operation is capable of providing desired control effects. The management, therefore, introduces various systems to facilitate the above. The systems inherent with feedback information are known as controls—collectively they are called internal control. An internal control pervades the organisation, however, it should be commensurate with the size and nature of business. It is an important and effective tool of management, to achieve the objectives economically. The management aims at optimum use of economic resources placed at its disposal and the internal control ensures this and does not allow the dissipation of said resources. It must, however, be kept in mind that since all the activities of the business are carried on with the help of human beings and equipments, both these need supervision. It, therefore, becomes necessary that the persons affected by controls are persuaded to participate in deliberations so that they

do not feel that their right of freedom of action is lost. There is a need also for proper explanation for how controls are to work and reasonable opportunity for people to adjust them and come out with suggestions.

Internal control does not restrict itself to accounting functions only, but extends to the administrative and other functions also. It also includes internal checks and internal audit.

MEANING AND DEFINITION OF INTERNAL CONTROL

Internal control is an important and effective tool of management to achieve organisational objectives effectively.

The system of internal control is defined by Spicer and Pegler as the whole system of controls, financial and otherwise, established by the management in the conduct of business including internal check, internal audit and other forms of control. This definition has the following implications:

- (a) Controls are established over financial and non-financial areas;
- (b) The mechanism of controls may be in the form of internal check or internal audit.

The management aims at optimum use of the resources through internal control.

Internal control comprises the plan of organisation and all the co-ordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies.

-According to the American Institute of Certified Public Accountants

It is not only internal check and internal audit but the whole system of controls, financial or otherwise, established by the management in order to carry on the business of an enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of records.

- According to Statement of Auditing issued by the Institute of Chartered Accountants of England and Wales

Internal control system means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

-According to Statement on Standard Auditing Practices AAS-6 (Revised) – Risk Assessments and Internal Control- Issued by the Institute of Chartered Accountants of India (ICAI)

The auditor has to report whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the

purchase of inventory and fixed assets and for the sale of goods. Whether there is a continuing failure to correct major weaknesses in internal control.

-As per the Companies (Auditor's Report Order), 2003

Internal control refers to the whole of measures taken, procedures introduced and methods established in an organisation for obtaining timely information about the orderly conduct of the business to achieve the organisational objectives. The measures, procedures and methods as whole are referred as internal controls.

The function of the internal control is to enable the adopted plan to operate efficiently, profitably and economically so that:

- (i) Duties and responsibilities for operations to individual employees are assigned to achieve the established policy of the company.
- (ii) Feed back to the management of the results periodically, particularly in regard to abnormal or unusual situations both favourable and unfavourable and deviation from the standards.
- (iii) To safeguard the interest of the company against fraud, waste and loss of efficiency or carelessness, fire, accident, theft, etc.
- (iv) To promote efficiency of personnel and operations.
- (v) To lay and circumscribe the definite units for performance of duties.
- (vi) To establish and circumscribe the definite limits within which the internal routines of the business must be conducted. The individual who violates the limits will have to explain and justify his action.

As a conclusion, internal control, means the whole system of controls, financial or otherwise, established by management in order to secure as far as possible the accuracy and reliability of the company's records and to safeguard, regulate and conduct all the activities of the business.



Internal control is a prescription and practice of a system by management. Internal control comprises the plan of organisation and all of the coordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies.

CLASSIFICATION OF INTERNAL CONTROL

Internal control can broadly be classified into two categories viz.:

1. Accounting controls/financial controls, and
2. Administrative controls.

(1) Accounting controls

Accounting controls comprise the plan of organisation and all methods and procedures that are concerned mainly with and relate to, the safeguarding of assets

and the reliability of the financial information. They generally include such controls as the system of authorisation and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations of assets custody, physical controls over assets and internal auditing e.g. budgetary controls.

Examples of each are (i) maintaining inventories is an accounting control whereas (ii) recording of visits by a salesman is the administrative control.

Internal control relating to accounting system aims at ensuring that:

- the transactions are executed in accordance with the management's authorisation;
- all transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability for assets;
- the access to assets is permitted only in accordance with the management authorisation;
- the assets are reviewed and verified at reasonable intervals and appropriate action is taken with regard to the variances.

It can safely be said that scope of internal control is much wider than that of accounting controls. Thus, internal checks, internal audit, quantitative controls, budgetary controls etc. can be said to be a part of the accounting controls, in so far as they deal with quantitative aspects. On a wider footing, accounting controls, operational controls, policy planning/review, reporting etc. can be said to be a part of internal control.

(2) Administrative Controls

A number of controls falling under operational controls can also be administrative controls. Examples of operational controls are: quality control, work standards, periodic reporting, policy appraisal etc. Administrative controls are very wide in their scope. They include all other managerial controls concerned with decision-making process. They are concerned with the authorisation of transactions and include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision-making. They include controls such as time and motion studies, quality control through inspection, performance budgeting, responsibility accounting and performance evaluation etc. Administrative controls have an indirect relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the financial records.

However, for the purposes of understanding the internal control we may study it in four parts as:

1. Accounting controls
2. Operational controls
3. Internal checks
4. Internal audit.

These are explained below summarily for a better comprehension of the subject, even though at the cost of repetition.

1. Accounting controls pertain purely to the accounting system which enter

finally in the preparation of financial statements and information which are subject to the expression of opinion by the auditors.

2. Operational controls are those which help in improving the efficiency, productivity and not necessarily enter the accounting systems. Works standards, quality control, methods study and motion study, critical path method etc. may be many examples of operational controls.
3. Internal check is a built in device in the day to day working by separating the duties and functions of the staff in such a way that the work of one is automatically checked by the other e.g. posting of cash transactions in the ledger is done by a person other than who handles the cash and writes the cash book — the cashier. This part shall be dealt with subsequently in detail.
4. Internal audit is an appraisal function to be performed on the principles and practices of audit. The scope of this extends to all the quantifiable information.

ELEMENTS OF INTERNAL CONTROL

The essential requirements for the success of a business are the implementation of organisational objectives, plans and philosophy. With this end in view the following may be considered as the elements of internal control.

(i) Segregation of duties

The division of an operation into a series of sub-operations undertaken by different people, allows for internal checks to take place. Such a control merely reduces the chance of error or irregularity occurring, but it does not eliminate the risk. It reduces the risk of intentional manipulation and error and increases the element of checking. Function which should be separated includes those of authorisation, execution, custody, recording and in the case of a computer based accounting system- systems development and daily operations.

(ii) Organisational structure

The structure or pattern of an organisation will mean system of arrangements and relations as between various levels of personnel for carrying out of plans and policies towards achievement of objectives for which the business stands. Enterprises should have a plan of their organisation, defining and allocating responsibilities and identifying lines of reporting for all aspects of the enterprise's operations, including the controls. The delegation of authority and responsibility should be clearly specified. It is important that critical operations are provided with the appropriate status and communications within the organisations. A common cause of irregularity is imbalance between responsibility, status and remuneration.

(iii) Objectives and Policy Statements

Objectives are the aims, goals, purposes or accomplishments which the top management lay down and expect the staff members to achieve. The functional segments of the company should comply with the policies, plans, procedures,

external laws and regulations and the work should be performed in a coordinated manner.

Policies and procedures give an indication as to the nature of personnel behaviour in their functioning and reflect the attitude of management. Functions of different staff members should be integrated in a manner that is complementary and each acts as check on the other. For instance, wage sheets should be prepared and checked by different set of staff and their disbursement should be in the presence of a responsible official.

(iv) Authorisation and approval

All transactions should require authorisation or approval by an appropriate responsible person. The limits of these authorisations should be specified. While designing procedures, provision should be made for proper authorization, to establish full accountability for the actions taken.

(v) Personnel

There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. In fact, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

(vi) Management

Management is responsible for establishing, monitoring and reviewing the systems of internal control. In practice, management may delegate the reviewing function to internal auditor. It is, thus the duty of internal auditor to provide management with reassurance concerning the efficiency and effectiveness of internal controls.

(vii) Records and Reports

The accounting and other records should be maintained accurately and adequately so as to assist the management in formulating present and future events in decision making and planning.

In order to make reporting effective, it should be timely, tailor-made and present all facts concerning problem areas, assessments etc.

(viii) Accounting Controls

These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, and that they are all included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances, and accounting for documents.

(ix) Protection of assets

These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to

authorised personnel. These include both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.

(x) Supervision

Any system of internal control should include the supervision by responsible officials of day-to-day transactions and the recording thereof. The supervisory role undertaken by staff should be allocated to those with proper training and suitability to such a function.

Illustration:

Risk Management and Internal Controls at Barings

Barings, a 200 year old merchant bank in England with a capital of 600 million dollars failed abruptly due to the mechanization of Nick Leeson, a derivative trader. The question however is that can a single person doom a financial giant? The Bank's collapse to a large extent is attributable to deficiencies in internal control and risk management systems.

Leeson was engaged in dubious trading, accounting and reporting practices so as to conceal the losses he was incurring. After the 1995 Kobe earthquake in Japan, Leeson was left with holding of a substantial number of call options which had become basically worthless coupled with put options. To cover his tracks, he used an "error account" to hide the true nature of his contracts in addition to reporting erroneous profits to senior management in London. In actual, there were losses of over millions of dollars.

It happened because the management of Barings had failed to ensure adequate segregation of various functions of Singapore operations which were handled by Leeson. Leeson was in charge of the dealing desk as well as controlled the back office operations. This provided him ample opportunity to falsify the reporting aspect of the business and bypass critical regulatory and compliance requirements. The potential of fraud and errors increases manifold in the case incompatible duties are vested in the same individuals. While the controls within Barings systems may have been appropriately designed, their operational effectiveness was always defective. The lesson of the case is that in the development of risk management and internal control system one must follow the time tested fundamentals necessary for effective internal controls. Having implemented an internal control system, it is essential to provide mechanism for monitoring and assessing its effectiveness. Though Baring's internal audit team had indicated the significant risk for control mechanisms, the management did not follow the recommendation. To top this all, Leeson besides being in-charge of two offices also had the cheque signing authority. The continued ineptness on the part of senior management led to the germination of a financial disaster. The need was for the management to implement controls sufficient to mitigate and manage the risk consistent with bank's risk appetite.

The approved strategy assigned to Leeson was simple arbitrage between futures contracts. It was a low risk strategy. The stated risk level was clearly incompatible with high level of reported profitability. The management failed to detect the mismatch. It points to ignorance of the management about business and basic risk

management principles. It felt satisfied with the high level of reported profits and did not want to disturb the goose that lay golden eggs. Had management followed the recommendations of audit team, a risk manager might have been in place. He would have adopted the mechanism necessary to safeguard the viability of the bank. There would have been created clear line of demarcation between the trading activities carried out by front office and the check and balance created by the back office. This would have lead to more accurate positions being reported. With this information senior management would have been in a position to assess the various exposures against its capital. For example, an assessment of risk weighted capital might have indicated that the bank was under capitalized and headed for trouble. Steps must have then been taken to protect adequacy of capital as well banks solvency.

Prudent management of liquidity risk dictates that management should have in place adequate contingency plans to meet unforeseen liquidity requirements. In the process of effecting risk management systems, especially for financial institutions, their should be a clear recognition that while failure to manage all other risks are likely to trigger the demise it is usually the inability to access liquidity in a manner which does not impose significant burden or losses to the institution which will cause it to fail. This is one of the reasons it is generally recommend that an integrated approach is taken to risk management. There is an implicit domino effect which is triggered with a breakdown in the management of specific risks. Certainly Barings management, if they did not understand this before were well educated after the collapse.

All things being equal, one person should not be able to take down an institution. As seen above the popular perception that one person was responsible for Barings demise may be a fallacy and a rather myopic view. To marry oneself to this position would be to lose very important lessons which the incident bears out. The preceding paragraphs only reflect on a minute aspect of the whole incident. Readers so inclined may find it useful to acquaint or reacquaint themselves with the broader facts with a view of seeing how it provides useful insight into the operations or risk management and internal control systems. We take the position that it is best to learn from other persons experience especially when the result of that experience is as calamitous as in the case of Barings.

What happened at Barings was plain and simply a breakdown in fundamental systems which should have protected the bank. These are effective compliance; robust internal controls; proactive risk management; sound oversight; timely remedial actions; knowledgeable management; and by extension good corporate governance. These factors all represent costs for any organization but, implemented properly, they are necessary and important utilization of resources. Having them properly embedded in the organizational culture, influencing how business is done is very important to the long-term viability of an entity. They not intended to retard profitability or restrict returns but in fact are geared at enhancing the longevity and sustainability thereof while providing a framework within which business objectives can be achieved without endangering the interest of shareholders and other stakeholders. To manage an organization devoid of these elements could result in an occurrence not unlike that experienced by Barings Bank.

Source: Crafting and Executing Strategy: Concept & Cases: Thomson, Arthur. A et al.

CHARACTERISTICS OF EFFECTIVE INTERNAL CONTROL

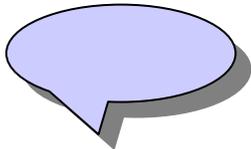
While nature of an activity or thing is the inherent quality which make what it is, the characteristics are the apparent features while in dealings or actions. Accordingly, the following should be considered as the characteristics of an internal control. Internal control of a business includes the whole system of controls i.e. operational, financial and managerial control. Controls are exercised through internal checks by the executives, by internal and statutory auditor and by various committees appointed to examine in-depth, certain aspects of business. Controls are also exercised to some extent by outside bodies like financial institutions; banks etc. who offer term loans for working capital. The main characteristics of an effective internal control system are stated as follows:

- (i) There should be proper delegation of authority, responsibility and duties within the organisation and any areas of conflict, misunderstanding and overlapping of duties.
- (ii) Appropriate monitoring system should exist for an analysis of performance and taking immediate corrective measures.
- (iii) In built facilities should exist for checking, cross checking and reconciliation of data by experienced employees including internal audit personnel, to ensure reliability, adequacy and correctness of all recorded transactions.
- (iv) The internal control system should not be expensive but should be commensurate with the benefits to be derived. The control system should be flexible and adjustable to the changing situational needs and should never be too tight to take away the initiative of the operational executives.
- (v) There should exist a system of authorisation and record procedures to provide reasonable accounting control over assets, liabilities, revenue and expenditure. The work of one person should become complementary to the work of another with a view to prevent and detect errors and frauds.
- (vi) Selection procedures are carefully screened to ensure that only qualified people are employed. Responsibilities are assigned according to individuals having requisite competence and qualification. The staff should have adequate facilities to carry out their work and duties.
- (vii) There should be plan of organisation which provides the segregation of functional responsibilities and allocation of duties in such a way that none is responsible for the entire transaction. Functional responsibilities should be attainable and not academic.
- (viii) Evaluation of control system is periodically done by internal auditors and weakness revealed therein are brought out suitably for improvements. Appraisal is necessary to keep control alive, vital and effective. Management should not be reluctant to take steps in formulating effective systems of control at any stage or at any line of organisational functioning.
- (ix) Control should be a continuous process and control measures should not be static but dynamic.
- (x) Control measures, should not be taken as substitutes for judgement. Control measures should be well conceived and operate with maximum efficiency and should not taken as substitutes for judgement. Controls should not be duplicating and repeating to avoid extra costs in their applications.

OBJECTIVES AND SCOPE OF INTERNAL CONTROL

Objectives are the end results to be achieved of an action or activity. They must be in consonance with the overall ones as the users may dovetail these results with confidence.

The following are the objectives of internal control:



- (1) to ensure the orderly and efficient conduct of business.*
- (2) to ensure that transactions are executed in accordance with management's general or specific authorization.*
- (3) to ensure that all transactions are promptly recorded with the correct amount, in the appropriate accounts and in the accounting period in which executed, so as to permit preparation of financial information within a framework of recognised accounting policies and to maintain accountability for assets.*
- (4) to ensure that access to assets is permitted only in accordance with management's authorization.*
- (5) to ensure accountability for assets.*
- (6) to ensure that the policies laid down are adhered to.*
- (7) to ensure confidence of reliability to the users of information.*
- (8) to ensure that the things take appropriate shape and finish at the shop floor and are corrected by timely actions through feedback information.*
- (9) to present or detect errors and frauds.*

Thus, the function of internal control is to enable the plans adopted by the organisation to operate effectively and efficiently.

We can easily comprehend from the definition itself as to what is the scope of internal control. Initially, it was considered that internal controls can be introduced in the accounting systems. However, with the enlargement of the scope of internal audit to the 'quantifiable information' scope of internal control, the internal audit of which is constituent automatically stood enlarged. Further, stagnation is the impediment in improvements which is against the law of nature. Developments are natural with the passage of time. Thus, with the development of economic environment and technology of production and products, the scope of internal control continued to enlarge.

Internal control system in operation has a great influence on the audit programme as its design and operations would largely be determined by the efficiency of the system.

The Council of the Institute of Chartered Accountants of India, in the statement on Auditing Practices, has recognised that the auditor is entitled to rely upon the safeguards and the internal controls instituted by the management. Thus, with the improvement in accounting controls for use to various audits as Cost Audit, Tax Audit, Internal Audit and others, the controls in the segment of operational activities found their place during the course of time e.g., quality control, work standards, periodical reporting, performance appraisal etc.

Whatever the scope of internal control having been enlarged, it has to be commenced with the size and nature of the business or activities involved.

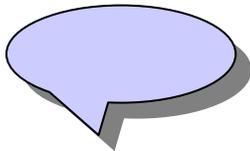
LIMITATIONS OF INTERNAL CONTROL SYSTEM

Internal control can provide only reasonable, but not absolute assurance that the objectives are achieved. This is because there are some inherent limitations of internal control as under:

- (a) Management's usual desire is that a control should be cost-effective, i.e., the cost of a control procedure should not be disproportionate to the potential loss due to fraud or error.
- (b) Most of the controls tend to be directed at anticipated types of transactions and not at transactions of unusual nature.
- (c) The potential for human error due to carelessness, distraction, mistakes of judgement or the misunderstanding of instructions can not be ruled out.
- (d) The possibility of circumvention of controls through collusion with parties outside the entity or with employees of the entity may be present.
- (e) The possibility that a person responsible for exercising control could abuse that responsibility, for example, a member of management overriding a control.
- (f) The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
- (g) Manipulations by management with respect to transactions or estimates and judgements required in preparation of financial statements.

TECHNIQUES OF INTERNAL CONTROL

The following methods are adopted for Internal Control in modern organisation:



- (1) *Internal Check*
- (2) *Internal Audit*
- (3) *Flow Charts*
- (4) *Internal Control Questionnaire*
- (5) *Inter firm and Intra firm Comparisons.*

(1) Internal Check

Accurate, complete and reliable record of accounting is a pre-requisite of good working of an organisation. The allocation of duties and responsibilities of an organisation should be such that the working is proved trust worthy. To help it further, the procedures and methods should also be designed accordingly.

Internal check has been defined differently by different authors and institutions connected with subject. The Institute of Chartered Accountants of England and Wales defines internal check as the allocation of authority and work in such a manner as to effort the checks on the day to day transactions which operate continuously as part of routine system whereby the work of one person is automatically proved independently or is complementary to the work of another, the object being prevention or early detection of error and frauds.

It is also defined as those measures and methods adopted within the organisation itself to safeguard the cash and other assets of the company as well as to check clerical accuracy of book keeping.

Thus, the term 'internal check' refers to allocation of duties in such a manner that the work of one person is checked by another while that other is performing his own duties in a normal way. Internal check is the organisation of duties of staff in a scientific way so that no one is responsible for all phases of the transaction and the work of one employee is so distributed that the discrepancies are revealed in the process of performance of duties of that employee. The duties are divided and subdivided in such a manner that discrepancies flow out from the system itself.

Briefly speaking, the internal check system may be referred to as a system of instituting checks on the day-to-day transactions which operate continuously as a part of routine system whereby the work of one person is complementary to the work of another, the object being the prevention or early detection of errors or fraud. The objective of such allocation of duties is that no single individual has an exclusive control over any one transaction or group of transactions.

The following are the important objects of internal check system:

- (i) To assign to a specific person, the responsibility of particular acts, defaults or omissions by allocation of specific duties.
- (ii) To obtain physical and financial confirmation of facts and entries physical and financial by creation and preservation of necessary records.
- (iii) To facilitate the breakdown of accounting procedures where required so as to avoid bottlenecks and establish an even flow of work and operations.
- (iv) To reduce the possibilities of fraud and errors.

The main purpose of introducing internal check is ensured by division of labour. The internal check should be arranged after the proper study of the requirement of each business.



As specified by Special Committee on Terminology, American Institute of Accountants, "Internal check—a system under which the accounting methods and details of an establishment are so laid out that the accounts and procedures are not under the absolute and independent control of any person - that on the contrary, the work of an employee is complementary to that of another and that a continuous audit of the business is made by the employees".

Essential Features of Internal Check

Essential features of internal check are given hereunder:

- (1) There should be proper division of work and responsibilities.
- (2) The duties of each person should be properly defined so as to fix definite responsibilities of each individual.
- (3) Possibilities of giving absolute control to anybody should not be left out unchecked.
- (4) Too much confidence on a person should be avoided.
- (5) The duties of staff should be rotated and one person should not be allowed to occupy a particular area of operation for long.
- (6) Necessary safeguards should be provided so as to avoid collusion of thoughts which quite often leads to commission of fraud.
- (7) The person handling cash, stock, securities should be given compulsory leave so as to prevent their having uninterrupted control.
- (8) Physical inventory of fixed assets and stocks should be taken periodically.
- (9) Assets should be protected from unauthorised use.
- (10) To prevent loss or misappropriation of cash, mechanical devices such as the automatic cash register, should be employed.
- (11) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.
- (12) Accounting procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

For introducing any system of internal check the work should be allotted on the basis of specialisation. The grey area where internal check could prove to be of much help are receipts and payments of cash, payment of wages, credit purchases etc. The nature and size of operation should also be given consideration while installing or introducing internal check system in any organisation. The success of internal check system would, by and large, depend upon the in-built safeguards introduced in the system. Instituting internal check system would reduce the work load of the auditor and make the accounting system more reliable. The internal check is of great importance to small as well as large companies, although this method of

operation will necessarily vary from that adopted in major concerns. In small organisation the number of employees is too few to establish an adequate division of duties so that supervisors or owners must claim more responsibility.

It is of importance that accounting procedures and working in any organisation is liable to changes and the system of internal check will have to be modified to suit the changed conditions. The pitfalls in the system are a warning to the auditor that something is wrong. If he disregards such a warning by failing to make the additional tests necessitated by the disclosed weaknesses he will not be able to perform his duties well and is liable to commit mistakes.

(2) Internal Audit

Internal auditing though part of an internal control is a function in itself as administration, production, personnel, marketing etc. Whereas internal check devises the form and flow of operations of an entity so that automatic checks are carried out as the transactions occur; internal audit is a critical appraisal of functioning of various operations of an enterprise including the system of internal check. This is evident in its definition itself as "an independent appraisal function".

'Internal auditing' in its traditional parlance, meant an audit on behalf of management to ensure only:

- (a) the adequacy and effectiveness of internal controls;
- (b) accuracy and timeliness of financial and other records and reports;
- (c) adherence to the laid down policies and procedures by each unit of the organisation.

Thus, with major emphasis on detection of frauds and ensuring accuracy of financial records, internal auditing was merely concerned with financial security by conducting routine checks. However, the modern world has witnessed dynamic changes in the manner of conducting activities by industrial and commercial organisations. Fast rising wages, increasing costs, cut throat competition, government's regulatory policies and globalisation have resulted in management's search for all round improvements, efficiency, economy and making an endeavour to provide the society with the best products at the most economical prices. As a result, the scope of internal auditing has been progressively widened to circumscribe a complete intra-company financial and operational review and fulfill its role as a tool of effective management control.

"Internal audit is an independent appraisal activity established within an organisation to examine and evaluate the activities as a service to the organisation. The objective of internal audit is to assist members of the organisation in the effective discharge of their responsibilities. To this end, the internal auditor furnishes them with analyses, appraisal, recommendations, counsel and information concerning the activities reviewed."

-As per The Institute of Internal Auditors

It is seen that internal auditing is not only confined to traditional functions like review of custodianship, safeguarding of assets and checking the reliability of accounting information but also encompasses new areas like review of economical

and efficient use of resources and ensuring optimum organizational performance. It is thus:

- (1) an independent appraisal function;
- (2) established within the organization;
- (3) to examine and evaluate the activities as a service to the management;
- (4) to assist the members for effective discharge of their responsibilities;
- (5) to furnish with analyses, appraisals, suggestions etc.

The following are the main aspects of internal auditing:

1. Review, appraisal and evaluation of the soundness, adequacy and application of financial, accounting and other operating controls.
2. Ascertaining the adequacy and reliability of management information and control systems.
3. Ascertaining the achievement of management objectives and compliance with established plans, policies and procedures.
4. Ensuring proper safeguards for assets - their utilization and accounting thereof.
5. Detection and prevention of fraud and error.
6. Ascertaining the integrity of management data in an organisation.
7. Identifying the areas of cost reduction, coupled with increased production, improved productivity and improved systems.
8. Ascertaining the quality of performance and undertaking 'value for money' exercises.
9. Compliance with statutory laws and rules including adherence to the Companies (Auditors' Report) Order, 2003 to avoid adverse comments from the statutory auditors.
10. Undertaking special reviews and assignments directed by management to ensure economical and efficient use of resources.
11. To provide for a channel of communicating new ideas to the top management.

Scope and Objectives of Internal Audit

The scope and objectives of internal audit are not uniform everywhere. They vary widely and are dependent upon the responsibilities assigned to it by management, the size and structure of the enterprise and the requirements of its management.

Broadly speaking, the objectives of the internal auditing are to provide an assurance to the management. It pertains to:

- (i) review of accounting system and related internal control;
- (ii) examination for management of financial and operating information;
- (iii) examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organization;
- (iv) physical examination and verification.

Thus, the overriding objective of internal auditing is to provide the management with a reassurance about the efficiency and effectiveness of operations that lead to the achievements of the goals of the organization.

Internal Check vs. Internal Audit

Internal control is a whole system of controls, of which internal check and internal audit are two important constituents. However they differ from each other in the following respects:

	<i>Internal Check</i>	<i>Internal Audit</i>
(i)	It is an arrangement of duties allocated in such a way that the work of one person is automatically checked by another.	It is an independent review of operations and records.
(ii)	There is no special staff to carry-out the system of internal check. It represents the arrangements of duties of the staff in a particular manner.	For carrying out internal audit, normally separate staff is engaged specially for the purpose.
(iii)	The objective of internal check is to reduce the errors and frauds.	The objective of internal audit is to discover the errors and frauds, if any.
(iv)	It represents a process under which the work goes on uninterruptedly and checking too is more or less automatic.	The internal auditor has to see as to how far the work is correct and done according to the specified rules.

Nature and Status of Internal Audit

Internal auditing is a management tool for periodical review of organisational systems and procedures to ensure overall efficiency of the organisation. In other words, internal audit is a management function which monitors the continuing validity of management control systems and their compliance. An effective internal audit department can greatly facilitate the task of the statutory or external auditor.

How does an Internal audit assists the members of the organisation in the effective discharge of their responsibilities?

Internal audit furnishes the members with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed. It is implied that an internal auditor has to go beyond the books of accounts records to appraise the quality of various activities of the organisation. He is not to confine himself to the routine search for clerical errors in accounting documents but has to conduct an appraisal of the various operational functions and provide advice and recommendations on the activities and operations reviewed by him. According to the modern concept of internal auditing, the internal auditor should also be engaged in the task of carrying out a review of operations.



The prime objective of a successful internal auditor is to create a structure of control within the corporate environment which is so effective that detection of fraud is automatically and extremely swift and theoretically, hardly ever likely to arise, because that system makes a fraud difficult to perpetrate.

Internal audit is an element of the internal control system set up by the management of an enterprise to examine, evaluate and report on accounting and other controls on operations. It exists either voluntarily or in certain circumstances because of a statutory requirement.

Originally the management thought that the internal auditor is primarily meant to protect the property of the company, to find out whether the financial records were reliable and capable of detecting frauds etc. The work of the internal auditor was also viewed as extension of the work of the statutory auditor. But now due recognition is being given to the functions of the internal auditor in the organisation on account of increasing range of managerial responsibilities arising from the complexity of modern business and non-business activities. The internal auditor not only deals with accounting and financial functions of an organisation but is also properly geared to deal with matters of an operating nature.

Internal audit acts as service to the management. It is established as a part of the process of monitoring performance to attain the organisational targets and adopt the plans. The role of the internal auditor has been substantiated from just checking that functions are being carried out in compliance with plans, to analysing the ability of the organisation to react to the volatile market conditions and furnishing unbiased opinion to the management on all aspects of policy implementation.

Internal audit is an aid to the business control and is not a substitute for management. The line manager or supervisor remains primarily responsible for his sphere of operations and cannot show off on the internal auditor his responsibilities. In this context, a process known as "self-audit" has developed in the industry. In actual practice, the operating personnel themselves employ the techniques of internal auditing so far as it relates to their own departments or functional areas.

Internal audit attempts to bring to light the defects and loopholes of existing methods and aids the establishment of new and better ways of controlling operations. It aims at better operation and profit improvement. Thus, internal auditing may be considered as an appraisal of control techniques employed by a firm and its performance which incorporates a whole gamut of review of intra-company, financial and operational activities in a methodical manner.

Functions and Responsibilities of Internal Auditor

The functions and responsibilities of an internal auditor include disclosure of weaknesses in the systems and procedures and service to management where there is any ineffectiveness in management controls and there may be scope for improving the efficiency of managing the business.

The Statement of Responsibilities issued by the 'Institute of Internal Auditors' provides that "The responsibilities of internal auditor in the organisation should be clearly established by management policy... The internal auditors' responsibilities

should be:

- (i) to inform and advise management and to discharge their responsibility in a manner that is consistent with the code of ethics of the Institute of Internal Auditors;
- (ii) to coordinate his activities with others so as to best achieve his audit objectives and the objectives of the organisation.

In performing his functions, an internal auditor has no direct responsibility for, nor authority over any of the activities which he reviews..." To put it in concrete terms, the major functions and responsibilities of internal auditor can be described as under:

(i) Reviewing and appraising operating controls

The internal auditor should determine whether the internal control system is in accordance with the organisational structure. At the outset the controls should be inbuilt in operating functions, if they are to be cost effective. Each control should be reviewed and analysed in terms of its costs and benefits. It should also be seen throughout the period of intended coverage. The verification by auditor focuses attention on the accuracy and reliability of the data prepared at the various levels of management; how useful is the data for the intended purpose and whether the work is being carried out in accordance with the policies and procedures laid down by management. The types of controls to be reviewed and appraised by the auditor would include the accounting, financial and other operating controls.

(ii) Review of compliance with policies, plans and procedures

Management is responsible for establishing the system designed to ensure compliance with policies, plans, procedures and applicable laws and regulations. The internal auditor should examine whether the systems are adequate and effective and whether the activities audited are complying with appropriate requirements. He should examine whether the management formulates the major accounting policies after due regard to their effect on the financial statements, both present and future. He should evaluate the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of enterprise. It is the duty of the internal auditor to see that reasons for non-compliance are found, analysed and suggestions are made by way of report to management so that steps are taken to avoid defalcations in future, to achieve the targets and comply with laws, rules and regulations.

(iii) Review of custodianship and safeguarding assets

One of the management's objective is to ensure that the assets are reasonably and adequately protected against loss and that they are properly managed and accounted for. In this respect the internal auditor should analyze the control systems to make sure that all assets are fully accounted for. He should verify the existence of the assets of the company and review the means of safeguarding the assets against losses, e.g., deterioration, fire, theft, negligent activity, illegal acts etc. He should also review the adequacy of the insurance cover for the various risks involved.

(iv) Economical and efficient use of resources

The internal auditor should appraise the economy and efficiency with which

resources are employed. He should check whether proper operating standards and norms have been established for measuring economical and efficient use of resources. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate, necessary and need review. The systems of identification and analysis of deviations from the standards should be examined. He can not refrain from the duty to review the working of the unit, department, branch, factory etc. of an organisation and find the causes of inefficiency and uneconomic working and suggest remedial measures for improved working. As a part of evaluating resource utilisation, he should identify the facilities which are under utilised, like under-utilised machines, unoccupied storage space, huge cash or bank balance, idle manpower, etc.

(v) Accomplishment of established objectives and goals

The internal auditor should review operations and programmes to ascertain whether the results are consistent with established objectives and goals, whether the goals or programmes themselves need to be revised in view of the changed circumstances, and whether the operations or programmes are being carried out as planned and report to the management accordingly. It should be examined whether the objectives are revised periodically in the light of changes in internal and external environment. The internal auditor should examine whether the objectives are expressed in precise terms. The reasons for variations in the budget and actual are to be analysed and reported for taking corrective action by the management. He should also make valuable suggestions for improvements in the working of the organisation.

(vi) Detection of frauds

The detection and prevention of frauds is one of the main objectives of internal audit. The internal auditor's role in detection and prevention of frauds, defalcation, misappropriation and embezzlement is to find the causes and to enunciate policies and procedures for the future. The internal auditor is responsible for identifying the areas of risk and theft which are likely to occur. He is also responsible for installing control system to prevent or atleast deter persons from manipulating or indulging in theft.

(vii) Review of relevance and reliability of information

The internal auditor should review the management information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies. He will examine the accuracy and reliability of the financial and operating records. He should examine whether the information contained in the reports is meaningful to the users. He should evaluate the reports as well as records with reference to their costs and benefits.

(viii) Review of organisational structure

The internal auditor should make an appraisal of the organisational structure to determine whether it is in consonance with the objectives of the enterprise and whether the assignment of duties and responsibilities are in harmony therewith. He should analyze the organisation chart to find out whether organisation structure is simple and economical and that no function enjoys undue importance over the others. He should see whether the lines of authority and responsibility are clearly

defined and communicated to all organisational levels. There should be proper span of control of different executives at different levels.

(ix) Training other company officials

The internal audit department should assist/train the new employees about organisational policies, procedures etc. access to all records, places, persons as it helps all the departments of the organisation.

(x) Compliance with Statutory Rules and Regulations

The Internal Auditor should also review the organisational compliance with the existing statutory requirements, rules and regulations of various Acts.

Internal Audit Pattern

A systematic audit pattern as under should be prepared and followed by an auditor to achieve the objectives of internal audit:

- Ascertain the nature of business.
- Ascertain the description of all operations of business, whether financial or otherwise.
- Understand the objectives of management and operating conditions of the business.
- Analyze the existing control measures, systems and procedures.
- Prepare an internal audit programme alongwith a schedule.
- Submit an unbiased internal audit report, clearly showing the observations and recommendations.

The internal auditor should apply a thoughtful approach to his work. He should be unbiased and critical, yet fair in his views and recommendations. He should review and evaluate the important organisational documents like Operating Manual, Systems Manual, Annual Reports, Accounting and Finance Manual, Sales and Purchase Manual, Correspondence, Memorandum and Articles of Association etc. He should also ascertain practices in similar businesses, inter-firm and intra-firm comparisons and standards and norms framed by various business associations and professional bodies. The auditor may if, required, verify the existence and effectiveness of internal control by designing an internal control questionnaire. He may also apply PERT and CPM techniques apart from formulating Compliance Tests, Adherence Tests and Substantive Tests. Various tools like financial ratios, flow charting, statistical sampling and computer auditing can assist the auditor in the efficient performance of his duties.

Requisites for Effective Internal Audit

The pre-requisites for an effective internal audit are as under:

- (i) Internal audit must draw managerial and operational aspects in addition to financial aspects.
- (ii) To be effective the internal auditor must have full support and confidence of

top management. In fact, the adjustment of the Internal auditor and his senior team members should be done by and with full involvement of top management.

- (iii) Based on the decision of management and keeping in view the scope of work, internal auditor should have a well defined audit programme so that audit can be carried out systematically.
- (iv) The required time for various audit activities should be planned and the auditor should try to adhere to his schedule so that he can submit his report on time and the management can take corrective actions in time.
- (v) The internal auditor should have a professional approach with the persons/ departments/functions audited.
- (vi) The internal auditor should also follow up the matters to ensure that corrective action is taken by the management in respect of suggestions made by him.
- (vii) Audit should preferably commence from the beginning of the year and report should be submitted as per the schedule drawn by the internal auditor.
- (viii) Organisational climate to be congenial for internal auditor to act without fear, favour or prejudice.

Internal Audit and Management

Internal audit is a management function which monitors the continuing validity of management control system and effective compliance. In fulfilling this role the internal auditor has to recognise opportunities for strengthening systems and procedures, for improving methods and for achieving greater efficiency all with the objective of increasing the contribution of each sector can make towards achieving corporate objectives. To infuse professionalism the internal auditors in order to achieve their constructive and protective objectives, have to establish a link between policy making levels and operating levels of the organisation. Internal auditing has become an important management tool for the following reasons:

- (i) Internal auditing is a specialised service to look into the standards and efficiency of business operations.
- (ii) Internal auditing is necessary to ensure compliance of the Companies (Auditor's Report) Order, 2003.
- (iii) Internal auditing acts as a management tool by pointing out the inefficiencies in operations and the drawbacks of the functional heads or departments. Generally functional heads are much interested to improve the day to day working, but hardly find time, energy and initiative to do the same. Usually these personnel are reluctant to report an unsound situation which might reveal their inefficiency/weakness.
- (iv) It can evaluate various problems independently in terms of overall management control and suggest improvements, since it is completely detached from day to day operational functioning of the business.
- (v) Internal auditing is complementary to statutory audit. A good internal audit system ensures an effective internal control system in an organisation.

- (vi) It is a real support to management in discharging their ever increasing responsibility towards the shareholders and the public in general in producing reliable statements in respect of the working of the company.
- (vii) It is a part of the internal control system of a company and its activities and services can be availed of at any time for any emergency services like investigation, detection of fraud or any significant job from the stand point of business.
- (viii) It is an integral part of management by systems in an organisation.
- (ix) Modern internal auditing is concerned with all phases of business activities. Management, operational and internal audit department, can be a good training ground for management development programmes and also for training new employees.

Internal Auditing and Statutory Auditing

Statement on Standard Auditing Practices (SAP) 7 recognises that "the role of internal audit function within an entity is determined by the management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and thus much of the work of internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures."

Following are the features of internal audit vis-à-vis statutory audit:

(a) Method of appointment and interests served

Internal auditors are appointed by the management and are part of the managerial function. They are usually employed by reasonably large concerns; when it is economically feasible to employ a special department with the specific duty of evaluating and reporting on the reliability and effectiveness of the accounting and operating systems of the company. Their activities and reports are therefore primarily of concern to management in its process of establishing sound business policies and seeing that laid down policies and procedures are followed. Statutory auditors, on the other hand, are appointed by the shareholders under the statute. Their reports are addressed to the shareholders and their function is to add credibility to financial statements and to report on the stewardship of management.

(b) Independence

Independence is a freedom of action and thought which enables the auditor to choose his own methods of operation and evaluation, and allows complete objectivity in reports. The external auditor has considerably more independence than the internal auditor as he is appointed by the shareholders and thus not dependant on management for directions. In addition to shareholders, other users of financial statements such as bankers and other creditors also place considerable responsibility on the external auditor. Independence is of considerable importance in auditing and the difference in importance between the internal and external auditor is a matter of degree only.

(c) Principal areas of interest

Each type of auditor will have as his main areas of interest, those aspects of the

firm's activities which are of greatest importance to those, whom he reports. Since management is concerned with the operational efficiency and adherence to policies, the internal auditor will devote a considerable portion of his time in reviewing the accounting and operating procedures of the company in order to determine whether established policies are being followed and whether other improved procedures could be devised.

The external auditor is concerned with the truth and fairness of the reports presented to the shareholders and shall therefore devote the major portion of his time on the verification of the accounting for assets, liabilities, owner's equity, revenues and expenses. He is concerned with the accounting system, and mainly those aspects which relate to the presentation of financial statements. He is more concerned with the accuracy of the financial results reported rather than efficiency of procedures and operations.

(d) Nature of Work

It would be very seldom that either type of auditor would make detailed checks of all transactions; both the internal and external auditor will rely upon tests and samples. However, the internal auditor is likely to devote more time and effort to detailed work than the external auditor.

(e) Scope

The internal audit is in compliance with the procedures laid down by management and they may differ from one undertaking to another depending upon their needs as also the perceptions of the management. But the scope of activities of the statutory auditors is determined by statute.

(f) Approach

The internal auditors are mainly concerned with ensuring substantial accuracy of records and to report upon specific problems which may be assigned to them by the management. On the other hand the external auditors are concerned with the truth and fairness of accounts. However, some of the means of achieving their respective objectives are common and similar and thus much of an internal auditors' work would be of immense help to an external auditor.

(g) Responsibility

Internal auditors are responsible only to the management of the organisation while external auditors are responsible to members/shareholders and outsiders, like government.

(h) Objectives

Internal auditors are the representatives of the management. They help the management with unbiased material information collected from the scrutiny of the activities of different departments so that they may take suitable administrative and policy decisions in time to attain the goals or targets laid down. The external auditors are engaged to give an unbiased and impartial report on the financial position of the company to the shareholders as well as outsiders. They are more concerned with the legality and validity of the transactions and with the fairness of accounts.

(i) Qualification

The qualification required for appointment of the internal auditor is determined by the management and it is not obligatory for him to possess qualifications prescribed under Section 226 of the Companies Act, but a statutory auditor must possess such qualifications.

(j) Performance

An internal audit is usually a continuous process and its main object is to make sure that transactions recorded in the books of account have been properly performed and duly authorised. An external audit may also be continuous, but in the case of very large undertakings this is not often practicable. Hence, in such case external audit is taken up usually at the end of the year when the organisation has completed the preparation of the financial statements.

(k) Reporting

The internal auditor submits his report to the management while the report of the statutory auditor is placed before the shareholders of the company. Generally, the internal auditor is required to make suggestions to the management as to how the organisation can be run economically and efficiently while the statutory auditor is not required to do so unless he is specifically asked for the same.

Co-ordination between Internal and External Auditors

Co-ordination between internal and external auditors is very essential and the Institute of Internal Auditors states that the degree of co-operation between the internal and external auditors should be based on:

- (i) periodic efforts to discuss matters of mutual interest;
- (ii) access to each others audit programmes, files and working papers;
- (iii) interchange/exchange of correspondence and reports;
- (iv) common understanding of audit techniques, methods, terminology etc.

It has been propagated that co-operation must be the rule, so that the best use of audit resources is encouraged.

Though, it is recognised that the role of the two auditors differs, both of them have a common interest in as much as they ensure that there is a system of internal controls and that the accounting system is adequate.

- The internal auditor having been appointed by the management is responsible to senior management, and the external auditor drawing his powers by a statute, is responsible for statutory duties, reporting to third parties (shareholders, the public, Parliament).
- The internal auditor in his capacity as a representative of the management looks at things from the management's view point whereas the statutory auditor or external auditor is primarily concerned with accuracy of accounts and their fairness.
- Again, there may be conflict in roles whereby internal auditors being responsible to management are not authorised to discuss certain specific matters with the external auditors and likewise external auditor may not wish

to reveal certain suspicions, discussions or confidential matters to internal auditor.

In present days, the external auditor is the major partner to any agreement on co-operation, and is able to examine documentation including audit records.

Co-ordination Areas

The chief internal auditor should ensure that internal and external audit efforts are co-ordinated. As the internal auditor's responsibility is to senior management, and not to the external auditor, internal auditor may only assist external auditor in so far as directed by senior management. The following areas will provide sufficient scope for co-ordination between the two auditors:

- (i) Preparation of schedules for receivables, inventories, creditors, loans and other liabilities;
- (ii) Evaluation of internal control system;
- (iii) Evidence for verifying contingent liabilities;
- (iv) Verification of assets;
- (v) Preparation of detailed schedules for support of control figures;
- (vi) Repetitive transactions.

Common Interests

Areas of common interest between the two auditors are the following:

- (i) The operation of an efficient system of internal check for ensuring that internal controls are adequate;
- (ii) An adequate reporting system to provide senior management with sound financial information;
- (iii) Verification of assets and liabilities;
- (iv) The reliability of records;
- (v) Prevention of fraud and waste;
- (vi) Physical verification and checks.

Review of the Work of Internal Auditor by the External Auditor

In order to maximise the use of resources, the external auditor should evaluate the performance of internal auditor prior to determining the workload to be undertaken by himself. The important criteria are as follows:

- (i) The external auditor should see that internal auditing is done by persons with sufficient technical training and proficiency; and the organisational status of the internal auditor.
- (ii) As an internal auditor is an employee of the organisation, he cannot be completely independent or detached. In normal circumstances he will report to the highest level of management and should be free of any other operating responsibility. The external auditor has to evaluate any constraint or restriction if placed upon him by the management.

- (iii) The external auditor should ensure that the internal audit work has been properly planned, supervised, reviewed and documented.
- (iv) The external auditor has to ascertain the extent of coverage of the assignments which the internal auditor has performed for the management.
- (v) The external auditor should review the internal auditors' working papers and notebooks to see that:
 - related audit programmes are adequate for external auditor's use.
 - appropriate evidence was obtained to have reasonable basis for conclusion.
- (vi) He should review the effectiveness of the system of follow up of regular internal audit exercises.

Specific Evaluation

Apart from the above mentioned review criteria, where the external auditor intends to use specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's working papers to satisfy himself that:

- (a) the scope of work and related audit programmes are adequate for the external auditor's purposes;
- (b) adequate evidence was obtained to afford a reasonable basis for the conclusions reached;
- (c) conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed;
- (d) any exceptions or unusual matters disclosed by the internal auditor's have been properly resolved.

The external auditor should document his conclusions in respect of the specific work he has reviewed.

Responsibility

The ultimate responsibility for the report on the financial statements rests with the external auditor. He cannot under any pretext take shelter on the plea that he has relied blindly on work of the internal auditor. This is because the internal auditor does not have any responsibility to the shareholders and public at large for the work performed by him.

Thus, the review of the internal audit function in large organisations has now become a statutory responsibility for the external auditor. The external auditor should collect necessary evidence in support of the decision when he relies on the internal auditors. He should also conduct proper enquiry as to the competence, objectivity and work performance of internal auditor before relying on the latter's work.

Problems Associated with 'Close Working Relationship':

- (i) *Use of internal audit to reduce external audit costs:* In order to reduce total costs the true costs of both auditors should be compared. Normally, not every organisation allocates the costs of the audit function in the same

manner as is done for external audit. This causes poor comparability of tasks.

- (ii) *The effect of the audit plan:* Any decision to amend the audit so as to allow internal auditor to directly assist external auditor must be compared to the work that would otherwise be undertaken by internal auditor. Such work will tend to be of an operational nature and not relevant to the year end or to statutory audit. Thus, the external auditor may cause a 'time lag' regarding the audit plans of the internal auditor, because of associated problems of rescheduling of ensuing audits.
- (iii) *Motivation of internal auditors:* The use of internal auditors to undertake external auditors' duties may cause resentment on their part as they regard such tasks as removal from their real work and may create a feeling that they are being used as 'second class auditors', and may affect their level of motivation.

According to the modern concept of internal auditing, the internal auditor is not to confine himself to the routine search for clerical errors in accounting documents but has to conduct an appraisal of the various operational functions and provide advice and recommendations on the activities and operations reviewed by him.

Thus, internal control is the whole system of controls, of which internal check and internal audit are two important constituents. By internal control is meant not only internal check and internal audit, but the whole system of controls financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard assets, and secure as far as possible the accuracy and reliability of records.

(3) Flow Charts

A flow chart is a graphic presentation of a process or a system. It may be defined as a graphic representation of the flow of operations and documentations in their correct sequence from the initiation of transaction to its final entry in the books. It may be described as a map of inter-related operations specially arranged to indicate the sequence and type of these operations as part of a larger unit. In practice, detailed narrative is replaced by standardised symbols and inter connected lines indicating the flow of operations or documentations. It provides a precise, concise and simultaneously a comprehensive view of what takes place in an organisation, i.e., what documents are raised, how are they dealt with, what are the various operations involved in terms of flow of cash and goods. It enables a complicated system to be understood easily.

The use of accounting procedures and internal control is more readily assimilated when presented in a graphic form, particularly where the system is complex and documents pass through many hands and are subject to alternative procedures. In such a case, narrative description of the system will necessarily be lengthy and difficult to present in a logical sequence.

A flow chart on the other hand depicts the same situation in a simple, comprehensible and concise manner by the use of symbols. The utility of the flow chart lies in its capacity of depicting not only the various phases of a system in a simple manner but also in showing their relationship and their relative importance. A

system which has various phases of varying importance with inter connecting links can best be understood through flow charts. A flow chart drawn up properly would provide clear visual picture of the activities of a section or department indicating the flow of documents and activities.

Essential Qualities of a Flow Chart

A good flow chart should have the following features:

- (i) The outline of a flow chart should be simple, useful and legible. It should be so laid out that too many lines do not cut each other.
- (ii) The flow lines should be kept short to make it easier for the reader to follow the trail.
- (iii) There must be a balance between simplicity and relevance. While all relevant details should be included, all irrelevant information, unnecessary narration/abbreviations should not be there in a flow chart.
- (iv) A flow chart must show as to what is in process—various internal control systems and procedures must be depicted clearly.
- (v) A flow chart should be as self contained as possible. Cross references should be avoided as far as possible. This is possible only when the documents flowing from one chart to another are minimum.
- (vi) Flow charts should be complete upto the final disposal of the documents or information.

As a general rule, flow charts should be prepared only for procedures that have accounting control significance. Procedures that have no accounting implications, for example, certain marketing or production activities, should be excluded from these activities. Flow charting techniques vary according to the purpose for which they are used. The technique should be such as to cater to the special needs of the auditor. It should be drafted in a manner so as to identify records, files and reports; provide descriptions of operations and related documents in the processing steps thereby leading to the disposition of copies of documents with audit significance.

The flow charts should show the complete path of types of transactions from their beginning to their end. For this purpose, a transaction can be defined as a series of business activities relating to an exchange involving money, goods or services or to any other change in an asset or liability that should result in an accounting entry.

Illustration:

All of the activities that result in a purchase of raw material being recorded in the accounts are part of a transaction; those activities would normally include preparing a purchase requisition, preparing and mailing a purchase order, recording the receipt of goods, matching the supplier's invoice with the record of goods received and the purchase order, approving the supplier's invoice for payment, paying the supplier, recording the purchase in the appropriate asset or expense account recording the liability and subsequent cash disbursement in the appropriate accounts and controlling the foregoing documents before and during the related processing activities.

In some companies, flow charts of most of the systems are available. In such a situation the auditor has to verify whether the system, as charted, is really in existence or not. For this he has to get acquainted with the scope and nature of the business of the organisation, the job allocation, and the organisational structure. He may then visit various sections and ascertain the flow of documents and existence of controls in practice. This would require discussions with various section heads. In-depth procedural tests of various kinds of transactions selected at random will also bring out the actual working of controls. In case flow charts of various systems are not available, the auditor will be required to prepare them by sketching the flow of operations, documents, goods, etc. from one section to another. This would require a comprehensive knowledge of the control system.

Advantages of Flow Charts

- (i) A flow chart is clear and concise to read. It helps the auditor to gain visual impression to analyse a system and find out as to how it works.
- (ii) It is easier to spot out the salient points of control and related weaknesses by using the flow charts for various procedures and control systems. Special symbols can be used to denote weaknesses and the absence of essential accounting controls.
- (iii) It gives a disciplined approach to understand even the complicated system quite easily, as there are no lengthy narratives which can lead to confusion.
- (iv) With the help of flow charts the auditor can determine the degree of reliance that he can place in the capacity of the system to produce true and fair accounts.
- (v) The system or any part of it may be presented as a totality, without any loss of detail. It ensures completeness of recording as far as possible because a missed stage would result in the flow line stopping in the mid-way.
- (vi) The link between procedures in one area and another can be depicted easily.
- (vii) Diagrammatic representation facilitates reference to particular features within a system more readily than pure narrative. It helps in making the internal controls more effective.
- (viii) New members of the audit team are enabled to participate in the audit work after a shorter induction period.

Disadvantages of Flow Charts

- (i) Intelligibility is often dependent on accompanying techniques as it requires the precise understanding of the symbols and flow lines which can not be acquired without proper training.
- (ii) Complications in a system may best be described in a narrative.
- (iii) It requires skill in drawing.
- (iv) It is a time consuming process.
- (v) It is difficult to update and as such is only accurate at one point of time.

- (vi) Though the best chart is the one which indicates the flow of one transaction right from its initiation to its final disposition, yet in practice, it is difficult to prepare one flow chart which indicates all aspects of a group of transactions.
- (vii) If multi-phase transactions are shown in one flow chart, it is very likely that the over all view of the transactions may be lost because of the clustering of too many details in one chart.

(4) Internal Control Questionnaires (ICQs)

For many years internal control questionnaires (ICQs) have provided the standard method of discovering the security features of a client's system of internal control, on the basis of which subsequent audit tests may be planned.

An internal control questionnaire is designed to review the system of internal control in force and to expose any weaknesses in that system. As such, the internal control is usually reviewed by means of a questionnaire which is substantiated where necessary, by memoranda and flowcharts. Hence, the questionnaire is to be framed in such a way as to highlight the key controls.

Internal control questionnaires (ICQs) are an interrogation package designed to give the auditor an overview of the controls operating in a system and allowing the identification of weaknesses therein. In other words, internal control questionnaires are a set of questions framed in an organised manner, about each functional area of an enterprise which has its own purpose of evaluation of the effectiveness of the internal control and detection of its weaknesses, if any. A questionnaire usually consists of several distinct sections to cover various areas like, purchases, sales, debtors, creditors, wages, cash etc. The questions are designed in such a way that detailed answers to them are dispensed with.

By and large, internal control questionnaires are applied by the auditor for the verification of the existence and evaluation of the effectiveness of the internal control system. The questions framed for the questionnaires should be so devised that an affirmative answer should indicate satisfactory internal control. On the other hand, the negative answers would mean otherwise. Negative answers should attract some more information by asking further questions which will bring to light the strong and weak points of the internal control system in the organisation.

Some of the general considerations as to how to assess the internal controls in operation are the following:

- ICQs must be reviewed and updated periodically and the questions should be listed under activity and accounting functions.
- Associated by an ICQ, the auditor is able to gain an impression of financial systems and the relevant parts of the auditee's organisation. Appraisal of the questionnaire enables the auditor to assess the weaker and the more reliable parts of the system of internal control.
- The auditor will then be in a position to advise the auditee where the system requires modification and also to plan his audit programme. The programme will test those areas which the questionnaire shows to be weak in matters of control.

An extended form of internal control questionnaire may be used both to record the client's accounting system and to evaluate the system of internal control. For this purpose the questionnaire should include questions which, when answered, will:

- (a) describe the system and procedures; and
- (b) identify the relevant controls.

Such a questionnaire might divide the system into appropriate sections, such as purchases and trade creditors, sales and trade debtors, and fixed assets. Examples of questions covering goods receiving procedures for a purchases system are as follows:

- How many goods receiving centres are there?
- Are supplies examined on arrival as to quantity and quality?
- How is the examination evidenced?
- How is the receipt of goods recorded at each centre?
- Are these records by a person independent of those responsible for ordering functions and the processing and receiving of invoices?
- How are receiving records controlled to ensure that invoices are obtained for all goods received?

It is useful for such questionnaires to have in addition to the questions and spaces for the answers, columns for the assessment of internal control and disposal of weaknesses, and a cross reference to the audit programme. It is also useful for this type of internal control questionnaire to have a column which can be marked with a tick (✓) where the answer indicates a satisfactory system and with a cross (X) where this is not so. The assessment of the system should be brought up to date each year. A further column may also be provided, in which there can be indicated how the client has been informed of the unsatisfactory points and any action which the client has taken to deal with them.

A large number of auditors' firms have developed standardised internal control questionnaires. Such questionnaires can be used in almost all auditing situations with slight modifications. As the auditor observes, tests, and reviews various aspects of internal control system, he completes these questionnaires. Some questions are also required to be answered by the various executives of the organisation. Normally, the questions are so designed that the answer can be given by merely ticking the appropriate word (Yes/No/Not applicable). However, space is provided below each question so that the answer can be amplified where necessary. The scheme of questions must be comprehensive and logical. The questions should follow a sequential pattern and should provide cross checks and corroborations wherever possible.

The issue of questionnaires is considered a necessity for the first year of the auditors' engagement. For subsequent years, the auditor may request the client to confirm whether there had been any change in the nature and scope of business in the intervening period, that requires a corresponding change in the control systems, or whether the control system in operation, in a particular area has undergone some change. If there has been a change, the auditor should take note of it and the relevant part of the questionnaire may be revised for answer by the auditee afresh.

Use of ICQs is an established assessment technique. The questionnaire is a standard document, designed by the firm using it, and comprises a series of questions, each of which raises an enquiry on internal control. It is divided into sub-sections which roughly corresponds with the clients' organisations/divisions. Any sections which are not applicable are obviously ignored. Likewise such a standard questionnaire should be supplemented, where necessary, in order to deal with aspects or controls that are particular to the accounting system under review.

Where a standard question seems irrelevant to the system under review, the intent behind it should be considered and the questions rephrased to fit the circumstances

A blank ICQ would normally be completed in the case of a new client if its size and complexity justifies this.

A completed ICQ should have an effective "life" of three to five years during which time only updating would be necessary. A new ICQ would be necessary in any event if a radical change in the system (e.g. the transfer from manual to mechanised data processing) had taken place.

The ICQ should be completed by a senior member of the audit staff after putting the questions to the appropriate company's officers during a series of interviews specially arranged for the purpose. It is important to note the instances where the officer concerned is clearly unaware of the workings of that part of the system for which he is nominally responsible. The answers to ICQ questions must be corroborated by members of the audit staff, on a test observation basis. This will ensure that the views presented by the ICQ accurately reflect the day to day procedures. These tests designed to ensure that the system is accurately portrayed in the audit files, are known by various titles, but are usually called "walk-through" tests. It is important to remember that they do not constitute part of the audit programme, which can be performed only after the internal control system has been satisfactorily assessed and appraised.

The questions in a well-drafted ICQ will facilitate a rapid assessment of the system. This is normally achieved by formulating questions in which:

- the relevant internal control criteria are implicit, so that no more than a "yes/no" answer is required to indicate compliance or lack, as the case may be; and
- compliance with the particular control is always indicated by the answer "yes" and weakness correspondingly indicated by the answer "no". This degree of simplicity is not possible in the case of every question, of course; for example, where the names of executive officers authorised to sign cheques are sought, or where the upper monetary limit of authority to authorise expenditure is to be recorded.

Advantages and Disadvantages of ICQs

Following are the advantages and disadvantages of internal control questionnaires:

<i>Advantages</i>	<i>Disadvantages</i>
(i) The questionnaire is, in effect a check list of the areas to be covered and militates against oversights.	(i) There could be a tendency to record unsubstantiated answers.
(ii) The “yes” and “no” answer type questionnaire clearly highlights weakness of internal control, the weak features (“no” answers), and the strong points (“yes” answers).	(ii) Deficiencies could exist in areas not specifically provided for in the questionnaire and may, therefore, be overlooked.
(iii) Since the auditor who has developed the responses, places his initials on the appropriate line, responsibility for a proper review is thereby established.	(iii) The questionnaire form does not lend itself to an appraisal of the over-all adequacy of the system. Moreover, no distinction is made between the various weaknesses disclosed as to their relative significance.
(iv) It facilitates the preparation of reports to the client on the internal control system.	(iv) Many of the questions are inapplicable for a small company.
(v) Because of the close relationship between the review of the internal control and audit programme, internal control enquiries serve to clarify the objectives of related auditing procedures which thereby assume added significance. This is especially helpful to relatively inexperienced auditors.	(v) It is difficult to obtain an overall view of the organisational structure of the company or the flow of record-keeping and operational procedures. Hence, the questionnaire should be supplemented by organisational charts and systems memoranda.
(vi) Changes in the system become more apparent as a result of comparison of the questionnaires from year to year.	(vi) The auditor must still use his judgement in reaching at conclusions in the system of internal control.
(vii) Can be used in conjunction with flowcharting and audit tests.	(vii) ICQs are by their nature general. They may not suit the specific situation of an organisation.
(viii) Useful for review purposes to have data in standard format.	(viii) They may encourage 'mechanical' replies.

(5) Inter-firm and Intra-firm Comparisons

Inter-firm comparison is a technique of comparing the performances, efficiencies, costs and profits of various concerns in an industry for assessing its own performance and ascertaining the reasons for any difference in performances/

efficiencies etc. Inter-firm comparison has been used on a large scale with the objective of making choice of investment by potential investors or to assess the stage of performance of a particular organisation vis-à-vis that of others.

Inter-firm comparison is not just a statistical survey but it provides to the management an instant and vivid picture of how the firm's profitability, its cost, turnover and other key factors affecting the success of a business compares with those of the other firms in the industry.

Intra-firm comparison, on the other hand, means comparison of two or more departments or divisions belonging to the same firm with the objective of making meaningful analysis for the purpose of increasing the effectiveness or efficiency of the departments or divisions involved.

Thus, both inter-firm and intra-firm comparison have the same objective with the difference that while former compares the performance of the firm with other firms, the latter compares the performance of its own division or departments. The comparison may cover the financial position or operating results or both.

Inter-firm Comparison as an Aid to Management

Inter-firm comparison is one of the main techniques available to management for higher management control and planning. Progressive management always asks itself the questions:

- (i) How is our unit performing in comparison to that of others?
- (ii) Are we operating as efficiently as we should?
- (iii) Are there areas of our business where improvements could be made?
- (iv) If we are successful, what are the 'strong points' on which our success depends?
- (v) How can we increase our efficiency and profitability?

The final accounts and balance sheet prepared by the business units every year, provide scanty information and inadequate data for objective and realistic assessment of the performance of business units. The figures available from these statements only give an indication of the profitability, stability, solvency and growth of a unit in a general way but do not throw any light on whether the business unit has really made the best possible use of all the available resources of men, materials, machines and capital and whether it has the optimum use of all the operating factors propitious for the unit during a particular period keeping it at a very high performance level as compared to other similar units. The answer, however, depends on the availability of more detailed data and the possibility of comparison of the competitive units in the same line of business.

Inter-firm comparison caters the management to this need and provides it with a vivid comparative picture showing its operating performance, financial results and product-cost structure compared with those of other firms of similar size, nature, industry or trade. It also stimulates the search for weaknesses and guides the search in the right direction of finding out what are the reasons for the differences observed. Its main aim is therefore to locate those areas in which an organisation performs

satisfactorily and those in which it lags behind others and has to improve. The whole idea of inter-firm comparison is based on the philosophy that, however satisfactory operational performance of the business unit may appear as per its own records, the genuine test of its success is that provided by the achievements and results of similar other units.

Inter-firm comparison involves bringing together of a number of similar firms, getting them to pool their statistics through an organisation they trust (generally the Industry Association) and which ensures the secrecy and confidentiality of the information relating to each of the participating firm. The firm then receives a report from the organization, showing comparative performance of each participant and containing data indicating reason for difference in performance. The different statistics may relate to financial and cost matters or to aspects of physical performance such as output per man hour. Whatever be the area of comparison, the inter-firm comparison aims at providing not just a mass of statistical data, but at answering specific business questions.

Inter-firm comparison is particularly useful to small scale units. Small scale units neither have the resources to employ the specialists in particular management fields, nor can afford management consultants. To such firms inter-firm comparison is a form of self consultancy and diagnosis.

The system of inter-firm comparison establishes independent check on the efficiency of production, administration, selling and distribution activities of an enterprise. It constitutes a useful tool in guiding their policies, in weeding out inefficiency in their manufacturing organisation and in improving productivity of the available resources.

It is the object of inter-firm comparison to help managing directors of participating firms to find out how and why the overall success of their business compared with that of others, differs. In this way, the inter-firm comparison will make participants aware of otherwise unnoticed weaknesses in their policies and operations. It can best achieve this if the ratios compared provide an indication of the overall success of each participant plus a few supplementary ratios carefully selected to answer the question-stage-by stage and in providing relevant details.

Approaches to Inter-firm Comparison

In general the simplest approach to the inter-firm comparison is to concentrate only on the absolute figures expressed in terms of rupee values or some other standard unit. But in the multitude of absolute figures, the real message is likely to be lost if only such figures are to be considered. Accounting ratios render great assistance in throwing light on the significance of various figures in relation to others. In many cases, the ratios indicate strength or weakness. For example, the short-term solvency can be determined with the help of current ratio and quick ratio while the overall profitability can be established with the help of 'rate of return on investment'. Inter-firm comparison may be a selective one, confined to financial success, cost comparison and labour productivity. The ratios bring about great economy in the figures and clarity in the presentations of overall picture of the results. It is this reason which underlies the significance of ratios for the purpose of inter-firm comparison. Although all the ratios can be used for the purpose of inter-firm

comparison, it is common to find the use of financial and operating ratios of which the following merit special attention:

1. Current ratio along with quick ratio.
2. Turnover ratios showing especially the debtors' velocity and stock-turnover.
3. Debt-equity ratio together with fixed charges cover e.g., number of times interest earned.
4. Return on investment together with all the profitability ratios e.g., gross profit ratio, net profit ratio and expense ratios.

In certain industries, it is possible to work out significant input-output ratios. For example, in the case of sugar industry, the figure of recovery as percentage of cane crushed is very significant. A comparison of this with the recovery figure of other sugar mills in the vicinity would be helpful in assessing whether crushing and manufacturing operations are upto the mark.

The ratios stated above would disclose the efficiency or otherwise of a firm in the field of production, sales, administration and marketing. This will also disclose whether or not the return on investment is favourable as compared to others.

In using the ratios the following factors must be considered:

1. The firms may adopt different accounting practices particularly in respect of inventory valuation, depreciation, provision of gratuity and so on. In this way the profit figure of one firm may be different from another firm though of same type in many respects.
2. Normally price level changes are ignored in the calculation of ratios with the result that there may be a great deal of distortion in the return of investment figure. Therefore, price-level changes must be taken into account before any inter-firm comparison is attempted.

Advantages of Inter-firm Comparison

An inter-firm comparison of financial performance is a highly useful tool for understanding the behaviour of financial variables for measuring the efficiency of different units in the industry. It pin points the stronger and weaker units and also indicates the trends of improvement or deterioration for them. It is helpful in highlighting the factors beyond the control of the industry which constrain performance of various units and require immediate attention of government and other agencies interested in the growth of the industry. The investor conducts inter-firm comparison for determining the status of security of investment as also the returns in the form of dividends. For the workers and their unions inter-firm comparisons provide a clear idea of the relative capacity of the firm in question in terms of wages and the wage scales, production bonus, increasing the possibilities of employment, etc., as well as the relative efficiency of the workers in particular firm vis-à-vis other firms in the same industry, or the same class of workers. The main advantages of inter-firm comparisons are the following:

- (i) The extent of weakness or potential improvement is highlighted by the comparison and each firm may try to improve the productivity of its factors of production.

- (ii) The manufacturer is able to update ratios with trends and to maintain and improve his position in relation to that of other manufacturers.
- (iii) It ensures unbiased and specialised reporting on particular problems of the firm.
- (iv) It develops cost consciousness among the participating firms and they are cautious in this respect at all levels of management.
- (v) It helps Government in effecting price regulations.
- (vi) It enables the business firms to evaluate the data relating to operations of the competitors, especially their cost structure, revenue realisations, profitability etc.
- (vii) A sound information as opposed to vague reports and the necessary standardisation of methods used to arrive at such information reduces the possibility of unfair competition.
- (viii) It helps the Government, regulatory agencies and researchers in getting extremely useful data and quantitative information which is used to improve policies and conducting in-depth analytical studies and research.
- (ix) It stimulates self-criticism and also identifies the various responsibility centres—for various operations and their economic evaluation in terms of corporate objectives.

Limitations of Inter-firm Comparison

In spite of the various advantages, inter-firm comparison is not free from drawbacks. The following limitations of inter-firm comparison may be noted:

- (i) If information or ratios are not properly collected/computed before they are used, comparison will be rendered difficult and absurd results may emerge.
- (ii) Most of the member firms do not disclose the relevant data as they consider it confidential. Thus, the information supplied may not always be reliable for comparison or decision making purposes.
- (iii) The middle management may not be convinced with the utility of inter-firm comparison and hence may not take interest.
- (iv) Unless there is a uniform costing system among the members, the information may not be strictly suitable reliable for the purposes of comparison as different members may imply different things by the usage of same terms.
- (v) In the normal course, a suitable base for comparison may not be available.
- (vi) In any comparison, time factor is an important element, any inter-firm comparison, which ignores this, will lead to misleading results which are not comparable and as such the very purpose of this exercise will be frustrated.
- (vii) The inconsistencies in financial reporting are totally ignored. No adjustment are made for changes in the prices. No attention is given to the level of technology and technological developments. Generally, there is a lack of common valuation method in different units compared. All these aspects adversely affect the reliability of the results obtained by inter-firm comparison.

In brief, the fundamental purpose of inter-firm and intra-firm comparisons is to increase the overall efficiency of an industry by making available relevant information on a uniform basis of interpretation. No auditor normally carries out this study as part of his routine function under an audit job. This does not also seem to be practically feasible. If, however, some units under the same company are required to be audited to complete the audit, such comparison should naturally be considered as an important audit function as the auditor may be required to report as regards the abnormal variations in cost and income factors in some units to clarify the position of accounting statements regarding disclosure of the true and fair view of the concern. To check the internal consistency and overall reasonableness of data, an auditor may attempt to comprehend the trends as revealed by the ratios of an enterprise over a number of years. He may also compare the ratios with external data such as industry statistics or statistics of similar companies. Trend analysis and inter-firm comparisons may, therefore, be useful to an auditor.

AUDIT OF INTERNAL CONTROL SYSTEM

The auditor's approach to the review of the accounting practices and internal controls should be systematic. Basically, the following may be considered as the steps in review and evaluation of a company's internal control and accounting procedures.

(1) Determination of the Established Controls

This is an initial study of the internal control system in an organisation. The auditor should be familiar with the accounting system, accounting and auditing manuals, flowcharts, accounting records and forms etc. This involves the auditor in questioning, observing, examining and investigating to determine the controls in a system. Once an opinion is formed this should be reproduced on paper in draft form and agreed with line management.

(2) Text of Transactions

The next phase of the review is the 'walk through' a number of transactions to accomplish the following:

- (i) Establish the correctness of the procedures and controls previously determined.
- (ii) Confirm that the procedures and controls are functioning, thus providing a valid basis for a preliminary evaluation.
- (iii) Enable the auditor to obtain a better understanding of the detailed operations of the system with limited contact.

The auditor may obtain reasonable assurance through compliance testing procedures by selecting samples from different categories of transactions and examining them in depth with regard to the procedural and control aspects. Compliance testing should be undertaken to identify weaknesses in and divergences from regulations.

(3) Documentation

After all the information has been gathered by the auditor, an overall

memorandum should be prepared describing the system, or the auditor may use a checklist of questionnaire or prepare a flow chart. If the company personnel prepare the flowcharts, it may be advisable for the auditor to work with duplicate copies so that any changes noted by the auditor can be incorporated subsequently into the final company chart. The flow chart can then be reviewed to compare the operation in theory with that in practice.

(4) Evaluation Process

Once the documentation of the review is completed, the auditor should review where controls appear to be strong and where they seem to be weak. The weaknesses should be evaluated to determine whether or not the damage is material or has the potential to be material. Having determined the effectiveness of a specific control, it is then necessary for the auditor to come to a further conclusion as to the reliance that can be placed on it and the extent to which further auditing procedures are necessary.

When the auditor has verified which internal controls exist and how they are functioning, the final determination of the audit procedures, and their timing and extent, may be decided. If internal controls are strong, the auditors will select basic audit procedures and perform only limited tests of the account balances affected by these controls. If internal control systems are evaluated as being ineffective, the auditor may perform extended audit procedures and expand the depth of tests.

(5) Application of Substantive Tests

The extent of additional tests or procedures selected by the auditor depends on the circumstances. If the auditor is of the opinion that the client's controls are effective and are functioning, additional assurance about the reliability of recorded data may be ensured by carrying out additional testing of controls, or by means of substantive tests. These tests are connected with the collection and examination of direct evidence to ensure accuracy and validity of records. Once the substantive tests have been completed they can be compared to the initial expectations of the system established by the compliance tests. If the substantive tests provide unsatisfactory results, further testing may need to be made, whilst if satisfactory, such information provides evidence on which an opinion can be formed.

(6) Documentation of Review

As strengths and weaknesses are discovered by the auditor they should be summarised in a separate schedule. For each strength noted, the auditor should select and note the basic audit procedures that are appropriate to the particular situation, with emphasis on what procedures could be eliminated or curtailed without affecting the quality of the audit or the results to be attained. For each weakness found in the company's system, the auditor should select and document those procedures that would explore each deficiency in depth.

(7) Reporting to Management

The auditor may report to the management of the company under audit any weaknesses found by him in the internal control system. This may be of help to the auditor in defending himself against charges of negligence. This report highlights the weaknesses so that the management may take necessary steps to remove them in

future. This may describe in reasonable detail the objectives and limitations of internal accounting controls and the auditor's evaluation thereof. These letters should generally distinguish between matters which are of vital importance and those which are of secondary importance. This letter is intended as constructive item of management advice, which not only reports inefficiencies and defects in the system of internal control, but also suggests methods of correcting or overcoming them. The letter issued by the auditor to his client should consider the peculiarities of each particular case.

(8) Follow-up

The last step in the review and evaluation of a company's system of internal control is the investigation by the auditor to determine if a management has accepted the recommendations for improvements and incorporated them into the system. In subsequent reviews of the system, changes in procedures should be examined to determine whether they are functioning properly. If the management does not adopt the recommendations of the auditor, then attention to the weakness must continue to be highlighted in the letter until corrective action has been taken. In addition, the auditor should meet the people at management level and discuss the recommended changes.

By following such an approach the auditor is trying to find out whether:

- there is an existence of adequately planned, controlled and supervised accounting system producing reliable information.
- there is an existence of adequate internal control system.
- there is an existence of a reliable system of control and accountability to protect the organisation's assets.

All internal control systems should be flexible to have scope for amendments and to enable an assessment to be made of the system's continued adequacy and reliability.

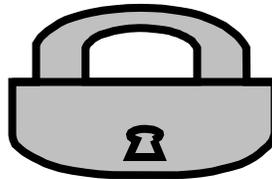
LESSON ROUND UP



- Internal control means the whole system of controls, financial or otherwise, established by management in order to secure as far as possible the accuracy and reliability of the company's records and to safeguard, regulate and conduct all the activities of the business.
- Internal control can broadly be classified into two categories i.e. accounting controls/financial controls: Accounting controls comprise the plan of organisation and all methods and procedures that are concerned mainly with and relate to, the safeguarding of assets and the reliability of the financial information.
- Administrative controls: Controls falling under operational controls can also be administrative controls.

- Elements of internal control include segregation of duties, organisational structure, objectives and policy statements, authorisation and approval, personnel, management, records and reports, accounting controls and protection of assets, supervision.
- The main characteristics of an effective internal control system include: proper delegation of authority, responsibility and duties, monitoring the system, facilities for checking, cross checking and reconciliation of data, economical, existence of authorisation and record procedures, proper selection procedures, evaluation of control system.
- The function of internal control is to enable the plans adopted by the organisation to operate effectively and efficiently.
- Internal check refers to allocation of duties in such a manner that the work of one person is checked by another while that other is performing his own duties in a normal way.
- Internal audit is an independent appraisal activity established within an organisation to examine and evaluate the activities as a service to the organisation. The objective of internal audit is to assist members of the organisation in the effective discharge of their responsibilities.
- A flow chart is a graphic representation of the flow of operations and documentations in their correct sequence from the initiation of transaction to its final entry in the books.
- Internal control questionnaires are a set of questions framed in an organised manner, about each functional area of an enterprise which has its own purpose of evaluation of the effectiveness of the internal control and detection of its weaknesses, if any.
- Inter-firm comparison provides to the management an instant and vivid picture of how the firm's profitability, its cost, turnover and other key factors affecting the success of a business compare with those of the other firms in the industry.
- Intra-firm comparison is comparison of two or more departments or divisions belonging to the same firm with the objective of making meaningful analysis for the purpose of increasing the effectiveness or efficiency of the departments or divisions involved.

SELF TEST QUESTIONS



1. "The extent of efficacy of internal control determines the scope of auditor's work". Elucidate.
2. "The function of the internal control is to enable the adopted plan to operate efficiently, profitably and economically". Discuss.
3. What are the elements of an effective internal control system?

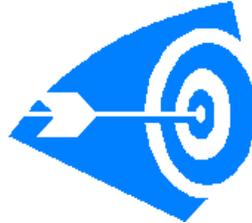
4. Discuss the main characteristics of an effective internal control system.
 5. What is meant by internal check? Give suitable examples and show how this relieves the auditor from a good deal of detailed verification?
 6. Discuss the purpose of implementing internal check system in an organization?
 7. What is meant by internal audit? State the objectives of internal auditing.
 8. Explain how internal check is different from internal audit.
 9. "There is coordination between internal auditor and statutory auditor in an organization". Elucidate.
 10. What are ICQs? How do they assist an auditor in reviewing the existing control measures? What are their advantages/disadvantages?
 11. What do you understand by flowcharts? Discuss their role in evaluating the internal control measures in an organisation?
 12. Are inter-firm and intra-firm comparisons relevant to audit? Explain.
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PART B - STRATEGIC ALLIANCES

STUDY IX

NATURE AND SCOPE OF STRATEGIC ALLIANCES

LEARNING OBJECTIVE



The objective of this study lesson is to enable the students to understand:

- Meaning of strategic alliance
- Types of strategic alliances
- Need for alliances
- Characteristics of strategic alliances
- Stages in the formation of strategic alliances
- Role of strategic alliances in corporate strategy
- Management of strategic alliances
- Cross-cultural alliances

INTRODUCTION

In an interdependent world every company is required to work in cooperation with others if it wants to compete in the global market. The global market place has spawned new strategic approaches in many industries. The forging of what have become known as strategic alliances has been noted by senior managements in all regions.



Merriam-Webster Collegiate Dictionary, tenth edition defines alliances as “associations to further the common interests of the members” or “intercorporate agreements covering a wide gamut of functions ranging from component sourcing through research and development to production and marketing.”

Alliances are used to enter new markets, access new technologies and achieve economies of scale faster and cheaper than any other acquisition method. The recent trend of collaborations consist of alliances varying from joint ventures, licensing deals, research consortia and technological exchanges to supply agreements and marketing alliances.

Alliances between companies have become a crucial weapon in the battle for competitive advantage. Mergers/acquisitions/strategic alliance can be termed as

coalescing and are becoming more and more popular. A “strategic alliance” is an excellent vehicle for two companies to work together profitably. Managed wisely, a strategic alliance can help companies develop and exploit their unique strengths. Through strategic alliances, organizations get an opportunity to widen their customer base, offload or utilize their surplus capacity, integrate vertically, use each others strengths and so on. For example, a large company can break down the marketing barriers that face a small company, which in turn brings entrepreneurial creativity to the partnership. An alliance can also be a powerful tool for accessing new technology and developing domestic or international business opportunities.

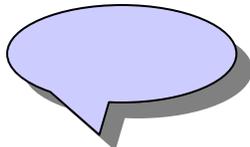
Corporate relationships are quite dynamic – an alliance that begins as a simple licensing agreement may blossom in time into a variety of technology sharing agreements, joint venture companies and cross equity shareholdings. Many companies form not only single partnerships but entire network of alliances. In general alliances set no time limits. Their duration is a function of the objectives and structures of the partnership, the prevailing business conditions and the management capabilities of the partners.

Many organizations however do not have a clear vision of their long-term direction. They are propelled by short-term tactical or operational needs. Such companies are prone to enter into alliances simply because a potential partner approaches them with a proposal. Most of the “strategic alliances” do not result in additional business, capabilities, or profitability for either of the companies involved, because they have not been well planned in the first place, and/or implementation has been left to someone else.

Establishing and managing winning alliances, starts with the crucial process of picking the right partner and creating realistic expectations on both sides. At the inception of the alliance, the intent of both parties must be clearly established. Analyzing the corporate and individual personality types involved in an alliance can help managers forecast and avoid problems due to lack of communication or mismatched value systems.

CHARACTERISTICS OF STRATEGIC ALLIANCE

Strategic alliance has three distinguishing characteristics:



- (i) the two or more firms that unite to pursue a set of agreed goals remain independent subsequent to the formation of an alliance.*
- (ii) the partner firms share the benefits of the alliance and control over the performance of assigned tasks.*
- (iii) the partner firms contribute on a continuing basis in one or more key strategic areas e.g. technology, products and so forth.*

Joint Ventures

Joint ventures are often confused with strategic alliances or partnerships. In fact, a joint venture is more like a partnership—with one major distinction: the joint venture is generally formed for the purpose of completing a single goal or a related series of goals in a business project. Depending on the agreement, the joint ventures may have the power to obligate each other and each may be liable, within defined limits, for the actions of the other on the project in question.

TRADING AND FUNCTIONAL ALLIANCES

All alliances involve some measure of inter-corporate integration—less integration than an outright merger, but more than a simple buy-sell relationship. Trading alliances are only a bit more complicated than traditional buy-sell relationship. Normally the objectives of such trading alliances include the need to secure supplies of product, buy or exchange skills/technology and exploit market networks. The main features of such alliance are management at arm's length, implementation at a fast pace, exclusivity, limited time frames with options to renew based on certain well-defined milestones.

On the other hand, partnerships involving an integration of business resources can take the form of functional alliances. Functional alliances are usually joint ventures or equity-based partnerships. They are characterised by management integration, open-ended collaboration, separate joint-venture entity and long-term commitment. Mainly the functional alliances aim at rationalising costs, revitalising core competencies, entering into new business and broadening strategic options. They bring companies into relationships demanding integration, with long term management implications.

NEED FOR ALLIANCES

Most firms enter into alliances out of need. According to an executive, "With alliances, we can do more for less". Whatever the needs driving alliance formation, managements must take the time to analyse why an alliance is the best strategy. The president of an Automotive industry had once explained, "Understanding why you need a partnership is the most critical step. Sorting out the whys in the equation will in turn dictate the answers to key issues such as with whom you want to collaborate, how the partners will combine their strengths, and how the venture will be structured and managed." The record suggests that ten main strategic factors reduce the whys in most alliance equations:

- (1) **Satisfy customer demands:** Customer demands in many markets are changing. For example, in office automation, customers now prefer a "systems solution" and want to rely on a single company to service all equipment.
- (2) **Share R & D costs:** High financial stakes and a cut-throat global market have fuelled a spate of competitive alliances in a number of industries.
- (3) **Fill knowledge gaps:** Companies that are leaders in their fields can maintain that position by using alliances to capture new developments, and keep their technological resource base ahead of the competition.
- (4) **Make scale economies:** Alliances can achieve the scale needed to

amortise investments.

- (5) **Make scope economies:** Alliances can enlarge dramatically the scope of a company's operations. Alliances focusing on scope help counter the ever-shorter product cycle of modern technology.
- (6) **Jump market barriers:** However potent the producer company's name may be in its "home" markets, that company may not market even its mature products best in international markets. Alliance marketing, franchising, distribution and licensing deals can leave a development-focused company free to concentrate on new products.
- (7) **Speed product introduction:** The narrowing of the development-to-market lead time has been a crucial feature of the past decade. In many sectors, the first company to introduce a new product enjoys a dominant market position and stands the best chance of recouping costs before the competition arrives to drive prices down-or before patent protection expires.
- (8) **Pre-empt competitive threats:** In industries in which a few large players increasingly dominate markets, some companies resort to an "if you can't beat them, join them" approach.
- (9) **Use excess capacity:** A large number of companies have used the restructuring effect of manufacturing alliances to soak up excess capacity.
- (10) **Cut exit costs:** Participants can use alliances to cut the costs of leaving a business.

ADVANTAGES OF ALLIANCES

Alliances are the quickest way to grow a company, particularly in times of change. Without implementing difficult and time-consuming internal changes, they allow a company to:

- Rapidly move to decisively seize opportunities before they disappear.
- Respond more quickly to change.
- Adapt with greater flexibility.
- Increase a company's market share.
- Gain access to a new market or beat others to that market.
- Quickly shore up internal weaknesses.
- Gain a new skill or area of competence.

Alliances can rapidly meet a company's need for key resources such as more customers, additional capital, new/better products, new distribution channels, additional facilities, increased production capacity, or competent personnel etc.

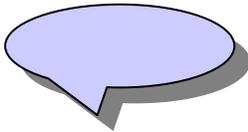
STRATEGIC ALLIANCES

Any arrangement or agreement under which two or more firms cooperate in order to achieve certain commercial objectives is referred to as strategic alliance. A true strategic alliance is a written arrangement between two companies that complement each other in a particular identified area. It is not a partnership, and

neither company has legal power to control or obligate the other. Instead, it is a commitment by the two companies to provide capabilities or cross servicing in certain identified areas. By properly utilizing a strategic alliance, companies can expand their product and service offerings substantially, without the usual corresponding investment in staff, equipment, and facilities. Strategic alliances are motivated by considerations such as cost reduction, technology sharing, product development, market access etc., Strategic alliances have objectives similar to those of conventional acquisitions but such alliances can prove to be less expensive than acquisition, if they are structured properly. This is because if two or more companies pool their resources they can secure their joint objectives more easily and economically.

TYPES OF STRATEGIC ALLIANCES

Alliance may be in the form of:



- *Management contract.*
- *Franchising.*
- *Supply or purchase agreement.*
- *Marketing or distribution agreement.*
- *Joint Venture.*
- *Agreement to provide technical services.*
- *Licensing of know-how, technology, design or patent.*

These arrangements differ in scope mainly by virtue of the following:

- Capital commitment.
- Structure of organisation.
- Decision making.
- Proportion between risks and reward.

Advantages

A business strategic alliance is also means to an end, not just an end in itself. Strategic alliances often take place between firms of different industries and of varied sizes, for vertical or horizontal links, consolidation of positions or any of the following:

- (1) Gain a means of Distribution in International market – It may be beneficial for an exporter to ally with local partner, to understand the functioning and the local market network.
- (2) Overcome legal or Regulatory barriers – In some countries it is mandatory to have local partners in order to conduct business. Thus, alliances offer suitable options.

- (3) Diversification – It may be advantageous to enter into an alliance, as a business guide to minimise pitfalls in a new business territory.
- (4) Avoiding competition – An alliance may be entered into with a market leader or a major competitor to avoid competition.
- (5) Focus on New Products and Restructuring – An alliance in the form of a research and development alliance may focus at the development of new products. Apart from this, an alliance may also enable the firm to adapt to a more effective organisational structure.

In addition to the above, the various perceived gains which may motivate strategic alliances include establishment of a business network, gaining cost and quality competitiveness, defend business interests, updating technology, starting new project, sharing of risks, increasing efficiency through economies of scale, specialisation etc.

INTEGRATING ALLIANCES INTO CORPORATE STRATEGY

Alliance strategy must be integrated into the overall corporate strategy and articulated in the strategic plan with a process for implementation. The entire process of developing and managing an alliance could be as follows;

- (a) Development of the strategic domestic or global plan
- (b) Development of the alliance plan
- (c) Alliance partner — search and selection
- (d) Development of the implementation plan
- (e) Execution of the implementation plan

Alliances are not part of every organization's strategic plan but are only one of the many options of a broad-based strategy. The integration of the alliance strategy into the overall strategy of the organization depends on the extent of the vision of the company for the future.

The kind of strategic planning that a company undertakes affects the nature of the alliances that a company enters into. If a company is willing to undertake long-term strategic planning, the alliances entered into as part of the long-term vision are likely to be those that take some time to come to 'fruition', such as research and development partnerships.

Medium-term strategy carries lower risk, owing to its short time horizon. Alliances used commonly as part of medium-term strategy include joint ventures, licensing or distribution relationships, etc.

The time frame of short-term or operational strategy is one to three years, where managers primarily look at financial and asset management with a narrow product and market focus for immediate results.

Corporate and alliance strategy is indispensable for smaller companies. In fact, it may not be possible for a small or start-up organization in any industry to go beyond its development stage, without a strategy that at least reaches from the operational and short-term into the business and medium-term approach.

Developing a global strategic plan is critical for developing international opportunities, which can be leveraged only by using the alliance process and learning the skills of managing cross-cultural alliances. In the international arena, the need for local expertise, cultural interpreters and the legal ramifications of entering foreign markets virtually mandate the development of alliances. Creating a global strategic plan involves analyzing inputs from strategic regions and combining that with a competitive analysis.

Options analysis

Analyzing options involves decisions on strategy, philosophy, corporate personality and structure. The process could be as follows:

- (1) Consider whether the company should be looking for an alliance and if so, why?
- (2) List and prioritize the reasons.
- (3) Identify the options for alliance structures, considering cost, risk and the commitment to human resources.
- (4) Focus on specific structures, keeping in mind an understanding of the organization's corporate personality. For example, if the corporate personality requires complete control rather than collaborative team building 'acquisition' may be the right alternative.
- (5) Relate the choices to the corporate strategy and strategic plan.

If the process generates specific options, the next step is a corporate self-analysis. After the corporate self analysis, the next major task is developing alliance partner criteria. Following closely on criteria development will be the partner search and evaluation process, negotiation and 'closure'.

PREPARING FOR THE ALLIANCES

Some companies have no problem in finding alliance partners. For many companies, however, the partner search is a tiresome and confusing exercise. The important steps necessary for good alliance creation and management are:

(a) Developing qualitative and quantitative partner criteria

The organisational culture and norms should be analysed, personnel functions should be analysed and the proposed criteria of partner to be selected should be outlined.

(b) Developing a list of prospective partners

It is essential that the partner analysis is proactive and not reactive. A partner that approaches a company may not be the optimum partner. It is therefore, necessary to examine other opportunities, if they exist. Accordingly, a list of prospective partners should be prepared.

(c) Partner Selection

While selecting a partner, companies must list the prospective standards against which they can measure the merits of a prospective partner; the most important being the three C's of successful alliances namely, Compatibility, Capability and Commitment.

Compatibility

In sizing up potential partners, the following need to be analysed:

- What is your partner's strategy? The most competent partner in the world won't make a good alliance if contradictory strategies collide within the alliance.
- How manageable are differences in corporate cultures? Every company has its own unique corporate culture. Managements need to weigh the kind of impact this will have on the alliance.
- How much compatibility exists among management practices and organisational structures? For instance, are both companies centralised or decentralised? Are both managements flexible enough and committed enough to overcome potential conflicts? Also, how compatible are customer-service policies and philosophies? Is there any differences in production strategies? Do you have the same attitude towards – and skills in – quality management? If the alliance is to be a separate joint-venture company, what are your respective compensation programmes, hiring strategies, etc? How do practices in labour relations compare? Are relations smooth or strike prone? How do managements view their employees?
- How do you and your prospective partner compare with respect to financial strength, risk orientation, dividend policies, reinvestment, debt-equity ratios, currency management, etc? Are the partners publicly held, privately held, state owned, etc?
- How compatible are policies on ethics and health, safety and environment? Many MNCs demand that partners share comparable philosophies and policies.
- What is a potential partner's alliance record? No (alliance) news can be good (alliance) news. A company without alliance experience is no less capable of alliance success than a veteran alliance-builder.
- Considerations such as interpersonal relationships are equally important to success. Even when the above factors fit well, the alliance can fail miserably if the people involved cannot get along

Capability

The capabilities of the potential candidates are obviously of prime importance, and companies may need to compile a dossier on each and evaluate their strengths and weaknesses. Among the issues to be considered are:

- Have you checked for complementary strengths? What most companies look for in a partner is the ability to contribute complementary strengths and resources to the alliance.
- Has a multi-functional team scrutinised the capabilities? Many alliance-practitioners recommend establishing a team of experts to undertake a feasibility study of the relationship.
- Is "compatibility" interfering with a rigorous analysis? It is said that companies should not make the mistake of letting apparent compatibility interfere with a thorough analysis of a partner's capabilities and resources.
- Is the potential partner's management stable and coherent? The

management structure of an ally may today appear capable of running the alliance but tomorrow it may prove to be otherwise.

- How does reality accord with a potential partner's own projection of itself? All companies try to present themselves in the best possible light. The danger sign should flash when investigations reveal the company's statements and what the balance sheet or independent analysts state are not the same.

Commitment

Finding a partner with an equal sense of commitment to the alliance is the third keystone to success. Even if partners appear capable and compatible, unless they are willing to invest the time, energy and resources to make the alliance a success, the chances of the alliance being able to change the market conditions are slim. In this regard following two important points can be tested to ascertain as to whether their potential partners share a sufficient degree of commitment to the alliance:

- (1) Does the alliance fall within a core business or product line of the partner? If the proposed alliance is in a business area that is only peripheral to the partner's mainstream activities, several dangers may exist. First, the partner may not devote the time and resources necessary to making the venture succeed. Second, the partner could easily withdraw from the alliance and leave to your disadvantage.
- (2) Determine how difficult it would be for a potential partner to withdraw from the alliance. One partner may incorporate the objectives into its global strategy, pour in considerable effort and resources, and suddenly be left high and dry if the other partner suddenly leaves.

(d) Partner Analysis

Once the potential partner has been identified, the next step is to analyse the strategic fit of the partner with the company. This can be done by asking some important questions like—

- Whether the relationship meet the mission statement goals?
- What is the strategic potential for the company resulting from a partnership?
- Is there another partner in the industry that would be a better prospect?
- What is the risk exposure for the company, arising out of the relationship, in terms of knowledge transfer?

As much information as possible should be gathered about the prospective partner so as to adapt and improve the understanding of the appropriateness of the partner for the stated goals of the company. The legal and accounting team of the company should be involved in researching the implications of the alliance.

(e) Obtaining internal approvals

The policies should be completely unambiguous and clear internal approvals should be obtained from the CEO and top advisory personnel to avoid embarrassment later.

(f) Creating an implementation plan

Alliances conceived entirely by the planning and corporate departments without

the active participation of the operational managers, who will ultimately have responsibility for the implementation of projects are bound to fail. It is therefore, essential that the operating managers are involved in at least the later stage of the negotiation process.

(g) Final predeal evaluation of all the relevant information

(h) Negotiating the deal

(i) Managing the legal process

Briefly, many of the mistakes made in planning an alliance have their origin in the lack of preparation. If the preparation is done well, with constant review of the plan, the potential for managing the alliance is greatly enhanced. The various factors potentially conducive to successful alliances are:

- (1) Partnership should be based on an optimum balance of business strength and ownership amongst partners.
- (2) The partners to alliance should bring in complementary skills, and capabilities to the alliance.
- (3) Conflict of interests by virtue of market overlap should be minimal and avoided as far as possible.
- (4) A degree of autonomy, strong leadership, continual commitment and support should be present.
- (5) Alliance should be capable of building trust and confidence among partners.
- (6) Sensitive and empathetic approach to be followed while dealing with divergence of management styles and corporate culture.

CROSS CULTURAL ALLIANCES

In a global economy with shifting labour markets, work migrates to wherever quality, cost and efficiency can be managed so as to derive a better return on capital and time invested. When an organization decides to enter the international market place, there are certain strategic management capabilities that must be modified and introduced into the corporate culture for the venture to be successful. The most important of these are flexible organizational culture, political risk awareness, decentralized strategic planning, multifaceted management structures and share authority/responsibility. Cross cultural joint ventures can thus reap enormous benefits, for companies.

The national culture in which an organisation operates, is to some extent influence the type of culture and style of work, organisations adopt. It has been observed that the first thing organisational members do in mergers, acquisitions and alliance situations is to make assessments and draw conclusions about the 'other culture'. It has been noted that the perceived threat of concentration and nationalism is a potential barrier to international alliances, M & A etc.

Differences between national cultures on such dimensions are likely to influence attitudes towards long range planning and time pressures. Cultures which are more bound by tradition are likely to emphasise past historical precedents and require considerably more detailed information before deciding, than cultures which are

tolerant of uncertainty and are more inclined to face risk. Differences in cultures have clear implications not only for the negotiation of alliance in terms of understanding how issues are perceived by the other party and presentation of the type and sources of information that are more congruent with their culture but also for joint formulation of future business strategies.

PLANNING THE CROSS CULTURAL ALLIANCES

National or social culture is a pervasive influence on the behaviour of societal members. However, if alliances between organisations based in different national cultures are to prove successful, both parties need to first appreciate and understand the different views and interpretations. This concerns identifying one's own cultural paradigm including the values, assumptions and beliefs which shape perceptions about others; comparing differences in management style, reward and decision making process etc. Apart from this, cultural awareness and language skills are important aspects in negotiating and working within international partnerships and alliances. Also, important personal qualities such as patience, interpersonal tact and empathy are also required.

In cross-cultural situations, while the process of alliance building is similar, the managers selected should be trained to become experts in the extra complications caused by cultural dissimilarities. Another factor that must be taken into account by those looking to develop cross-cultural alliances is the fact that there are sub-cultures within many country cultures. Consequently, it is important to verify that the cultural assumptions that are being made for the alliance have been modified for the particular sub-cultural characteristics. For example, in a country like India, there are many regional, ethnic, religious and industry sub-cultures prevalent. Similarly, regional differences exist in other parts of the world. Cross-cultural competition for labour and technology is a reality that is impacting every company that does business internationally and cross-cultural alliances must adapt as well.

Thus, important difference in developing a plan for a cross-cultural alliance is that the 'key skill' of the managers involved in building such alliances must be the ability to work in ambiguous, unfamiliar, cross-functional and trans-cultural relationships. Understanding the issue of cultural differences in the way information is communicated and applying these understandings is critical to the success of such alliances.

UNDERSTANDING CROSS-CULTURAL ALLIANCES

As most alliances are cross organizational and cross-cultural, so, it is a challenge as to how to create and deal with such alliances. The key obstacles to the success of cross-organizational relationships, are given below -

Coping with Increased Complexity: The newly emerging organizational system in the formation of strategic alliances is by definition significantly more complex. No individual or group has experience working with the combined entity. Many organizations whose greatest skill is at the functional level may also find it difficult to manage the cross-functional and cross-cultural repercussions of their own activities. Even organizations that have mastered cross-functional thinking may find it challenging to manage cross organizational ripple effects

Aligning Differing Orientations: Organizations' orientations can vary in terms of focal length (short-term vs. long-term), philosophical emphasis (strategic vs. operational), and integration of goals.

Short-Term vs. Long-Term Focus: The delicate balancing of addressing short-term needs while investing in the long term is never easy. However, through experience most businesses learn to walk that tightrope. Unfortunately, in an alliance each partner must consider how its short-term actions will affect the other's long-term success. Often actions that make perfect sense in the short term end up producing the unintended consequence of undermining the long-term value of the relationship.

Strategy vs. Operations: Individual organizations may sometimes function effectively despite having divergent operational and strategic goals. However, the success of an alliance may depend on the degree to which these very different orientations are integrated. Alliances frequently form because of the theoretical strategic advantage of envisioned joint capabilities. However, once the alliance is in place, those theoretical capabilities must quickly become real—and successful. Otherwise, the alliance is likely to fall apart.

In most organizations different groups are responsible for strategy and operations, and these groups do not combine their respective knowledge during decision making. The strategic thinkers may have a clear picture of the long-term business opportunities, but will tend to underemphasize the difficulties of actually implementing new capabilities and the ways that alliance activities might hurt the existing organization. On the other hand, the operational team, motivated by incentives to improve current performance, will focus on the implementation challenges and will be less aware of or interested in the strategic possibilities. Thus, an all-too-frequent scenario for an alliance is that senior managers enthusiastically create a grand vision while “leaving the details to be worked out by others”.

The difficulties in a strategic alliance are the same as those within individual organizations, only exponentially more complex. It is therefore essential for cross-organizational alliances to adopt “connect and comprehend”, paradigm.

Cultural Integration: Companies coming together with a clean slate i.e., without any negative preconceptions, but different cultures, may quickly find the variations in their behavioral norms are creating breeding ground for misunderstanding, poor follow-through, and eventual distrust.

For example: In one joint venture between a major consumer products manufacturer and a small, innovative drug developer, cultural differences quickly caused conflict between the participants. The manufacturer had a well-established hierarchical culture. There were strict behavioral norms, appearances counted, and promotions depended on being the prime mover behind successful endeavours. The drug developer was a young company with independent-minded staff, accustomed to working in an informal, nonhierarchical fashion. The problem was compounded by the need of each group's representatives in the venture to prove their contribution to the parent company, which made them aggressive in competing for leadership positions.

IMPLEMENTING AND MANAGING THE ALLIANCES

The success or failure of an alliance is dependent on how the venture is structured, the kind of managers placed in charge and the responsibilities and strategic missions are divided among the partners. The alliance implementation or

management plan must thus be formalized jointly with the partner. The plan is generally a written document, which should *inter alia*, answer the following questions:

- Who will do what?
- How will contributions be made?
- What communications mechanism will be in place for approvals?
- How will the information flow?
- Who will be the liaison from each company?
- How will the partnership fit in the existing relationship of both companies?

Part of the implementation plan must be a process to keep the partner informed on both positive and negative developments, on all alliance-related activities. The implementation plan should outline both partners' expectations. These need to be consistent and aligned in order for the partners to feel that they are gaining appropriate responses from the other side.

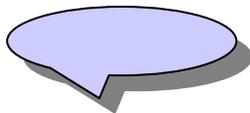
An important part in the management of an alliance is the creation of standards for project reporting and documentation. A critical issue that must be agreed upon at the start of the alliance is what constitutes success for the alliance as a whole. However, success is a 'moving target' and the success criteria can be changed as the partnership matures.

Managing an alliance is relatively new art. Finding the right mix of management ingredients for success can be quite daunting. Certain key success factors are:

- **Mutual Trust:** Mutual trust at senior management level carry ventures through turbulent times.
- **Ability to companies:** When there are two strong companies, the ability to compromise is not easy to achieve. If you expect to receive some valuable technology, production or marketing know how from a partner, you must be willing to give something.
- **Favourable business condition:** Launching an alliance when favourable business conditions exist makes a venture life considerably easier for its partners.
- **Alliance Autonomy:** The autonomy mandates a high degree of responsibility and good judgement by the ventures management.

Alliance Success Factors

Successful alliances generally share the following strategic characteristics:



- *Dynamic management structure*
- *Encouragement of calculated initiatives*
- *Systematic task setting*
- *Equal distribution of authority*
- *Streamlined communication channels*
- *Development of multi-manager roles*

The benefits of alliances can be leveraged by adequate internal communication mechanisms. Managing alliances will test even the most competent of executives. The capabilities include not only careful planning and implementation, but also a broad perspective and an open mind.

ALLIANCES CHECKLIST

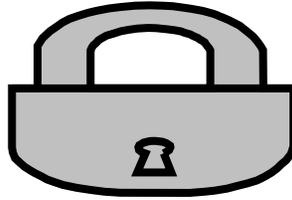
Following is the alliance checklist that captures the key points. These represent a useful starting point for any company's alliance strategy.

1. Don't get left behind. Alliances are here to stay. They are a permanent part of the corporate finance and corporate-development tool kit.
2. Understand the differences between alliances and Merger and Acquisition. Alliances represent a distinctive form of corporate control.
3. Understand when they make sense strategically and when they do not.
4. Avoid using alliances as a substitute for merger and acquisition.
5. Align the company's alliance strategy with corporate strategy. In particular, know the role of alliances in company's growth strategy.
6. Alliances are a way to keep options open in order to participate in growth opportunities.
7. Spreading the risks of failure among multiple partners, alliances allow a company to limit its downside exposure.
8. Actively manage alliance portfolio. Over time, weed out the value destroyers and nurture the successful partnerships.
9. Develop a structured alliance process. Be as systematic in selection of partner and negotiation as in the pursuit of a merger or an acquisition.
10. Continuously monitor alliance performance on the basis of explicit criteria for performance.
11. Ambiguous governance undermines commitment. Ensure that the governance mechanisms are clear.
12. Most alliances don't last forever, so have a clear exit strategy.
13. Once active portfolio of alliances is in place, it's important to establish a strong capability in alliance management.

LESSON ROUND UP



- A strategic alliance is form of cooperative strategy in which firms combine their resources and capabilities to create competitive advantage. With increasing complexity and dynamism strategic alliances has become integral component of the success story of modern organizations.
- Strategic alliances may mainly take three forms: joint ventures, equity strategic alliance and non-equity strategic alliance.
- In a joint venture firms create a new legal entity and own equal shares in it to develop a competitive advantage. In equity alliance firms own different shares of the newly created venture. In non-equity alliance firms cooperate through a contractual relationship.
- Alliances make strategic sense in situations of high uncertainty and in markets with growth opportunities that a company either cannot or does not want to pursue on its own.
- One of the main reasons to engage in an alliance is to share risk and limit the resources a company must commit to the venture in question.
- As most of the alliances are cross cultural they must overcome three principal kinds of hurdles: coping with increased complexity, aligning contrasting orientations, and combining cultures.
- Principles for successful strategic alliances:
 - Articulating Goals
 - Selection of Appropriate Partners
 - Working at Strategic and Operational Levels
 - Organizational Alignment
 - Dealing with Conflicts and Cultural issues.
 - Maintaining Strong Executive Sponsorship
 - Experimenting and Committing to Learning
- Managing Alliances – A Structural Approach
 - Aligning the Alliance Strategy with the Growth Strategy
 - Conducting a Rigorous search for Partner
 - Negotiating the Deal
 - Managing the Alliance
 - Evaluating Alliance Performance
 - Adopting a Portfolio Approach
 - Alliance Check List

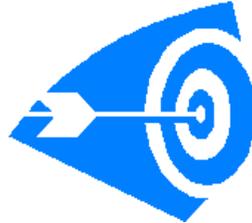
SELF TEST QUESTIONS

1. What is 'Strategic alliance'? What are the different types of strategic alliances?
2. What are the preliminary steps required for an alliance?
3. What are the advantages of alliances? Enumerate the parameters of a successful alliance.
4. What are the benefits and problems of cross cultural alliances?
5. What are the factors to be kept in mind while managing an alliance?

STUDY X

FOREIGN COLLABORATIONS AND JOINT VENTURES

LEARNING OBJECTIVES



The objective of this study lesson is to enable the students to understand:

- New Industrial Policy
- Foreign Direct Investment
- Automatic Route
- Government Approval
- Foreign Technology Agreements
- Procedure for Foreign Direct Investment
- Procedure for Foreign Technology Collaboration
- Foreign Collaborations and Joint Ventures
- Modes of Joint Venture
- Indian Joint Ventures Abroad
- Direct Investment Outside India
- Capitalisation of exports and other dues
- Investment in Equity of Companies Registered Overseas/Rated Debt Instruments

INTRODUCTION

Industrialization is a major objective of developing countries as a means to the attainment of higher levels of economic well-being of the people. Advancement of science and technology provides the stimulus to achieve faster industrial growth. The process of acquisition of technology involves a sequence of inter-linked activities, such as identification of technological needs in the light of the objectives of economic and social developments, the obtaining of information on alternative sources of technology, including local sources, the dissemination of information on technologies to potential users, the evaluation and selection of most appropriate technology, unpackaging of technology packages in order to assess the suitability, costs and conditions of their components, negotiation of terms and conditions, optimum exploitation and the use of results of exploitation of technology in the country.

After four and half decades of strongly inward oriented policies, India began opening up of its economy to foreign trade and investment with the announcement of New Industrial Policy in July 1991. The New Industrial Policy sought to prepare Indian industry for meeting the challenges of globalization. The reforms aim at

generating a market orientation for the hitherto highly regulated domestic economy by deregulating the domestic economy to provide Indian industry with greater flexibility to respond to competitive pressures by reducing costs and improving quality.

The New Industrial Policy has injected a substantial measure of competitive environment and market thrust to industry. Many areas earlier reserved for the public sector are now open to private sector participation. The restrictions on the expansion of large industrial houses have been removed. Licensing requirements for industries have been abolished except for a few strategic and defence industries.

The policy reforms towards Foreign Direct Investment (FDI) began with a radically new approach to FDI in the very first year of the implementation of New Industrial Policy. The new regime permits FDI in virtually every sector of the economy. Foreign equity proposals need not be accompanied by technology transfer as required earlier. Royalty payments have been considerably liberalised, no restrictions on the use of foreign brand name/trademarks for internal sale.

In view of the major changes introduced in the Indian economy and the liberalization of Industrial and trade policies consistent with the fast changing international economic and trade relations, it has become necessary to create a better and more conducive atmosphere for increased inflow of foreign investment and capital in the country to accelerate industrial growth and promotion of trade, with greater emphasis on export.

INDUSTRIAL POLICY RESOLUTION, 1948

Immediately after independence, the Government gave a careful thought to the economic problems facing India and recognised that any improvement in the economic conditions of the people is possible only through a substantial increase in the generation of national wealth as a mere distribution of existing wealth would not make any significant difference to the people. Thus, a need for a dynamic national policy directed towards a continuous increase in production and productivity by all possible means, side by side with measures to secure its equal distribution was felt. The Government in this context adopted in 1948 an Industrial Policy Resolution, a historic document and a trend setter, which emphasised on importance to the economy of securing a continuous increase in the production and its equitable distribution and pointed out that state must play a progressively active role in the development of industries.

The resolution envisioned that besides arms, ammunition, atomic energy and railway transportation, to be the monopoly of the Central Government, the States would be exclusively responsible for the establishment of new undertakings in basic industries except where, in the national interest, the State itself found it necessary to secure the cooperation of the private enterprise. The rest of the industrial areas were thrown open to private enterprise, though it was made clear that the State would also progressively participate in this field.

Recognising the valuable role of private enterprise in the economy, the resolution emphasised that the States could contribute more quickly to the increase of national wealth by expanding its present activities where it is already operating and by

concentrating on new units of production in other fields, rather than acquiring and running existing units. The resolution also recognized the importance of participation of foreign capital and enterprise, particularly in relation to industrial technology and knowledge, for the rapid industrialization of India. The Industrial Policy Resolution 1948 was provided legal support by enacting Industries (Development and Regulation) Act, 1951 and vesting in the Government necessary powers to regulate and control the existing and future undertakings.

INDUSTRIAL POLICY RESOLUTION, 1956

The Industrial Policy Resolution of 1956 laid down the basic approach towards industrial development. The new policy thrust rightly recognised the Directive Principles of State Policy enshrined in the Constitution and the adoption by the Parliament in December 1954 of the socialist pattern of society as the objective of social and economic policy.

In order to realise the socialistic pattern of society, the Government recognised the need to accelerate the rate of economic growth and to speed up industrialization and, in particular, to develop heavy industries and machine making industries, to expand the public sector. The Government also felt the need to prevent private monopolies and the concentration of economic power in different fields in the hands of small number of individuals.

The Government classified industries into three categories. The first category included those industries the future development of which was the exclusive responsibility of States. The second category included progressively State owned industries and areas in which the States had to take initiatives to establish new undertakings, though the private participation was also expected to supplement the Government efforts. The third category included all the remaining industries with the responsibility of private sector for their development.

The Industrial Policy Resolution of 1956 was followed by the Industrial Policy Statement of 1973 which, *inter alia*, identified high priority industries for investment by large Industrial houses and foreign companies. Emphasis on de-centralisation and on the role of small scale, tiny and cottage industries was the hallmark of the Industrial Policy Statement of 1977. The Industrial Policy Statement of 1980 focussed attention on the need for promoting competition in the domestic market, technological upgradation and modernisation. The policy laid down the foundation for an increasingly competitive export base and for encouraging foreign investment in high technology areas. These policies created a climate for rapid industrial growth in our country. A number of policy and procedural changes were also introduced in the years 1985 and 1986 aimed at increasing productivity, reducing costs and improving quality.

STATEMENT ON NEW INDUSTRIAL POLICY, 1991

This statement was tabled in the Parliament on 24th July, 1991, at the time when the Government of India faced severest foreign exchange resource crunch. This document admitted candidly the policy distortions of the past and expressed the Government's earnestness to achieve a break through in its policy formulations.



The statement states that “the major objectives of the new Industrial Policy package will be to build on the gains already made, correct the distortions or weaknesses that may have crept in, maintain a sustained growth in productivity and gainful employment and attain international Competition.....” Pursuant to this, the Government initiated a series of measures in the areas of Industrial licensing, foreign investment, foreign technology agreements, public sector policy.

New Industrial Policy, 1991

The Industrial Policy Resolution of 1956 and the statement on Industrial Policy of 1991 provide the basic framework for overall industrial policy of the Government. Over the years, adjustments have been made in the policy to accelerate the pace of industrial growth by providing greater freedom in investment decisions keeping in view the objectives of efficiency and competitiveness, technological upgradation, maximisation of capacity utilisation and increased growth.

The thrust of the New Industrial Policy of 1991 has, therefore, been to inject new dosage of competition in order to induce greater industrial efficiency and international competitiveness. The domestic competition has been induced by delicensing of industries and liberalising the policy related to foreign direct investment.

Since July 1991, the Indian industry has undergone a sea change in terms of the basic parameters governing its structure and functioning. The major reforms include large scale reduction in the scope of industrial incensing, simplification of procedural rules and regulations, reduction of areas reserved exclusively for the public sector, disinvestment of equity in selected public sector undertakings, enhancing the limits of foreign equity participation in domestic industrial undertakings, liberalisation of trade and exchange rate policies, rationalisation and reduction of customs and excise duties and personal and corporate tax.

With a view to ensure efficient allocation of resources, banking and capital markets also came in for major economic reforms. The banking sector reforms included substantial interest rate deregulation, liberal incensing of private sector banks, and expansion of the branch network of foreign banks. The capital market reforms aimed at de-linking capital market from direct government controls, by a system of better disclosure, greater transparency and wider investor protection.

Separate policy measures were announced in the form of specific packages aimed at upliftment of the small scale, tiny and cottage industries as well as 100% Export Oriented Units, and units located in the Export Processing Zones and Technology Parks.

FOREIGN DIRECT INVESTMENT

INTRODUCTION

Foreign Direct Investment (FDI) is a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a

'lasting interest' in an enterprise (the direct investment enterprise) i.e. resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.

The Government of India, Department of Industrial Policy & Promotion, Ministry of Commerce and Industry issued the Consolidated FDI Policy from time to time. This consolidation deals comprehensively with all aspects of FDI Policy which are covered under the various Press Notes/Press Releases/ Clarifications issued by DIPP.

ORIGIN OF INVESTMENT IN INDIA

A non-resident entity (other than a citizen of Pakistan or an entity incorporated in Pakistan) can invest in India, subject to the FDI Policy. A citizen of Bangladesh or an entity incorporated in Bangladesh can invest in India under the FDI Policy, only under the Government route.

NRIs resident in Nepal and Bhutan as well as citizens of Nepal and Bhutan are permitted to invest in the capital of Indian companies on repatriation basis, subject to the condition that the amount of consideration for such investment shall be paid only by way of inward remittance in free foreign exchange through normal banking channels.

OCBs have been derecognized as a class of Investors in India with effect from September 16, 2003. Erstwhile OCBs which are incorporated outside India and are not under the adverse notice of RBI can make fresh investments under FDI Policy as incorporated non-resident entities, with the prior approval of Government of India if the investment is through Government route; and with the prior approval of RBI if the investment is through Automatic route.

An FII may invest in the capital of an Indian company either under the FDI Scheme/Policy or the Portfolio Investment Scheme. 10% individual limit and 24% aggregate limit for FII investment would be applicable even when FIIs invest under the FDI scheme/policy. The Indian company which has issued shares to FIIs under the FDI Policy for which the payment has been received directly into company's account should report these figures separately under item no. 5 of Form FC-GPR (Post-issue pattern of shareholding) so that the details could be suitably reconciled for statistical/monitoring purposes. A daily statement in respect of all transactions (except derivative trade) have to be submitted by the custodian bank in floppy/soft copy in the prescribed format directly to RBI to monitor the overall ceiling/ sectoral cap/statutory ceiling.

No person other than registered FII/NRI as per Schedules II and III of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations of FEMA 1999 can invest/trade in capital of Indian Companies in the

Indian Stock Exchanges directly i.e. through brokers like a Person Resident in India.

A Foreign Venture Capital Investor (FVCI) may contribute upto 100% of the capital of a Venture Capital Fund/Indian Venture Capital Undertaking and may also set up a domestic asset management company to manage the fund. All such investments are allowed under the automatic route subject to SEBI and RBI regulations and FDI Policy. However FVCIs are also allowed to invest as non-resident entities in other companies subject to FDI Policy.

TYPES OF INSTRUMENTS

Indian companies can issue equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares subject to pricing guidelines/valuation norms prescribed under FEMA Regulations. The pricing of the capital instruments should be decided/determined upfront at the time of issue of the instruments.

Other types of Preference shares/Debentures i.e. non-convertible, optionally convertible or partially convertible for issue of which funds have been received on or after May 1, 2007 are considered as debt. Accordingly all norms applicable for ECBs relating to eligible borrowers, recognized lenders, amount and maturity, end-use stipulations, etc. shall apply.

The inward remittance received by the Indian company vide issuance of DRs and FCCBs are treated as FDI and counted towards FDI.

Issue of shares by Indian Companies under FCCB/ADR/GDR

(i) Indian companies can raise foreign currency resources abroad through the issue of FCCB/DR (ADRs/GDRs), in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India thereunder from time to time.

(ii) A company can issue ADRs/GDRs if it is eligible to issue shares to persons resident outside India under the FDI Policy. However, an Indian listed company, which is not eligible to raise funds from the Indian Capital Market including a company which has been restrained from accessing the securities market by the Securities and Exchange Board of India (SEBI) will not be eligible to issue ADRs/GDRs.

(iii) Unlisted companies, which have not yet accessed the ADR/GDR route for raising capital in the international market, would require prior or simultaneous listing in the domestic market, while seeking to issue such overseas instruments. Unlisted companies, which have already issued ADRs/GDRs in the international market, have to list in the domestic market on making profit or within three years of such issue of ADRs/GDRs, whichever is earlier. ADRs/GDRs are issued on the basis of the ratio worked out by the Indian company in consultation with the Lead Manager to the issue. The proceeds so raised have to be kept abroad till actually required in India. Pending

repatriation or utilization of the proceeds, the Indian company can invest the funds in:

- (a) Deposits, Certificate of Deposits or other instruments offered by banks rated by Standard and Poor, Fitch, IBCA ,Moody's, etc. with rating not below the rating stipulated by Reserve Bank from time to time for the purpose;
- (b) Deposits with branch/es of Indian Authorized Dealers outside India; and
- (c) Treasury bills and other monetary instruments with a maturity or unexpired maturity of one year or less.

(iv) There are no end-use restrictions except for a ban on deployment/investment of such funds in real estate or the stock market. There is no monetary limit up to which an Indian company can raise ADRs/GDRs.

(v) The ADR/GDR proceeds can be utilized for first stage acquisition of shares in the disinvestment process of Public Sector Undertakings/Enterprises and also in the mandatory second stage offer to the public in view of their strategic importance.

(vi) Voting rights on shares issued under the Scheme shall be as per the provisions of Companies Act, 1956 and in a manner in which restrictions on voting rights imposed on ADR/GDR issues shall be consistent with the Company Law provisions. Voting rights in the case of banking companies will continue to be in terms of the provisions of the Banking Regulation Act, 1949 and the instructions issued by the Reserve Bank from time to time, as applicable to all shareholders exercising voting rights.

(vii) Erstwhile OCBs who are not eligible to invest in India and entities prohibited from buying, selling or dealing in securities by SEBI will not be eligible to subscribe to ADRs/GDRs issued by Indian companies.

(viii) The pricing of ADR/GDR issues should be made at a price determined under the provisions of the Scheme of issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India and directions issued by the Reserve Bank, from time to time.

(ix) The pricing of sponsored ADRs/GDRs would be determined under the provisions of the Scheme of issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India and directions issued by the Reserve Bank, from time to time.

Two-way Fungibility Scheme

A limited two-way Fungibility scheme has been put in place by the Government of India for ADRs/GDRs. Under this Scheme, a stock broker in India, registered with SEBI, can purchase shares of an Indian company from the market for conversion into ADRs/GDRs based on instructions received from overseas investors. Re-issuance of ADRs/GDRs would be permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the Indian market.

Sponsored ADR/GDR issue

An Indian company can also sponsor an issue of ADR/GDR. Under this mechanism, the company offers its resident shareholders a choice to submit their shares back to the company so that on the basis of such shares, ADRs/GDRs can be issued abroad. The proceeds of the ADR/GDR issue are remitted back to India and distributed among the resident investors who had offered their Rupee denominated shares for conversion. These proceeds can be kept in Resident Foreign Currency (Domestic) accounts in India by the resident shareholders who have tendered such shares for conversion into ADRs/GDRs.

ELIGIBILITY OF FDI IN RESIDENT ENTITIES

FDI in an Indian Company

Indian companies including those which are micro and small enterprises can issue capital against FDI.

FDI in Partnership Firm/Proprietary Concern

(i) A Non-Resident Indian (NRI) or a Person of Indian Origin (PIO) resident outside India can invest by way of contribution to the capital of a firm or a proprietary concern in India on non-repatriation basis provided;

- (a) Amount is invested by inward remittance or out of NRE/FCNR(B)/NRO account maintained with Authorized Dealers/Authorized banks.
- (b) The firm or proprietary concern is not engaged in any agricultural/plantation or real estate business or print media sector.
- (c) Amount invested shall not be eligible for repatriation outside India.

(ii) *Investments with repatriation benefits:* NRIs/PIO may seek prior permission of Reserve Bank for investment in sole proprietorship concerns/partnership firms with repatriation benefits. The application will be decided in consultation with the Government of India.

(iii) *Investment by non-residents other than NRIs/PIO:* A person resident outside India other than NRIs/PIO may make an application and seek prior approval of Reserve Bank for making investment by way of contribution to the capital of a firm or a proprietorship concern or any association of persons in India. The application will be decided in consultation with the Government of India.

(iv) *Restrictions:* An NRI or PIO is not allowed to invest in a firm or proprietorship concern engaged in any agricultural/plantation activity or real estate business (i.e. dealing in land and immovable property with a view to earning profit or earning income there from) or engaged in Print Media.

FDI in Trusts

FDI in Trusts other than Venture Capital Fund (VCF) is not permitted.

CONDITIONS ON ISSUE/TRANSFER OF SHARES

The capital instruments should be issued within 180 days from the date of receipt of the inward remittance or by debit to the NRE/FCNR (B) account of the non-resident investor. In case, the capital instruments are not issued within 180 days from

the date of receipt of the inward remittance or date of debit to the NRE/FCNR (B) account, the amount of consideration so received should be refunded immediately to the non-resident investor by outward remittance through normal banking channels or by credit to the NRE/FCNR (B) account, as the case may be. Non-compliance with the above provision would be reckoned as a contravention under FEMA and would attract penal provisions. In exceptional cases, refund of the amount of consideration outstanding beyond a period of 180 days from the date of receipt may be considered by the RBI, on the merits of the case.

Issue price of shares

Issue price of shares to persons resident outside India under the FDI Policy, shall be on the basis of SEBI guidelines in case of listed companies. In case of unlisted companies, valuation of shares has to be done by a Chartered Accountant in accordance with the guidelines issued by the erstwhile Controller of Capital Issues (CCI).

Foreign Currency Account

Indian companies which are eligible to issue shares to persons resident outside India under the FDI Policy may be allowed to retain the share subscription amount in a Foreign Currency Account, with the prior approval of RBI.

Transfer of shares and convertible debentures

(i) Subject to FDI sectoral policy, foreign investors can also invest in Indian companies by purchasing/acquiring existing shares from Indian shareholders or from other non-resident shareholders. General permission has been granted to non-residents/NRIs for acquisition of shares by way of transfer subject to the following:

- (a) A person resident outside India (other than NRI and erstwhile OCB) may transfer by way of sale or gift, the shares or convertible debentures to any person resident outside India (including NRIs).
- (b) NRIs may transfer by way of sale or gift the shares or convertible debentures held by them to another NRI.
- (c) A person resident outside India can transfer any security to a person resident in India by way of gift.
- (d) A person resident outside India can sell the shares and convertible debentures of an Indian company on a recognized Stock Exchange in India through a stock broker registered with stock exchange or a merchant banker registered with SEBI.
- (e) A person resident in India can transfer by way of sale, shares/convertible debentures (including transfer of subscriber's shares), of an Indian company in sectors other than financial services sectors (i.e. Banks, NBFC, Insurance, ARCs, CICs, infrastructure companies in the securities market viz. Stock Exchanges, Clearing Corporations, and Depositories, Commodity Exchanges, etc.) under private arrangement to a person resident outside India, subject to the specified guidelines.
- (f) General permission is also available for transfer of shares/convertible debentures, by way of sale under private arrangement by a person resident outside India to a person resident in India, subject to the specified

guidelines.

- (g) The above General Permission also covers transfer by a resident to a non-resident of shares/convertible debentures of an Indian company, engaged in an activity earlier covered under the Government Route but now falling under Automatic Route, as well as transfer of shares by a non-resident to an Indian company under buyback and/or capital reduction scheme of the company. However, this General Permission is not available in case of transfer of shares/debentures, from a Resident to a Non-Resident/Non-Resident Indian, of an entity engaged in any activity in the financial services sector (i.e. Banks, NBFCs, ARCs, CICs, Insurance, infrastructure companies in the securities market such as Stock Exchanges, Clearing Corporations, and Depositories, Commodity Exchanges, etc.).
- (h) The Form FC-TRS should be submitted to the AD Category-I Bank, within 60 days from the date of receipt of the amount of consideration. The onus of submission of the Form FC-TRS within the given timeframe would be on the transferor/transferee, resident in India.

(ii) The sale consideration in respect of equity instruments purchased by a person resident outside India, remitted into India through normal banking channels, shall be subjected to a Know Your Customer (KYC) check by the remittance receiving AD Category – I bank at the time of receipt of funds. In case, the remittance receiving AD Category – I bank is different from the AD Category – I bank handling the transfer transaction, the KYC check should be carried out by the remittance receiving bank and the KYC report be submitted by the customer to the AD Category – I bank carrying out the transaction along with the Form FC–TRS.

(iii) AD Category – I banks have been given general permission to open Escrow account and Special account of non-resident corporate for open offers/exit offers and delisting of shares. The relevant SEBI (SAST) Regulations or any other applicable SEBI Regulations/provisions of the Companies Act, 1956 will be applicable.

Prior permission of RBI in certain cases for transfer of capital instruments

(i) The following instances of transfer of capital instruments from resident to non-residents by way of sale require prior approval of RBI:

- (a) Transfer of capital instruments of an Indian company engaged in financial services sector (i.e. Banks, NBFCs, Asset Reconstruction Companies, CICs, Insurance companies, infrastructure companies in the securities market such as Stock Exchanges, Clearing Corporations, and Depositories, Commodity Exchanges, etc.).
- (b) Transactions which attract the provisions of SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 1997.
- (c) The activity of the Indian company whose capital instruments are being transferred falls outside the automatic route and the approval of the FIPB has been obtained for the said transfer.
- (d) The transfer is to take place at a price which falls outside the pricing guidelines specified by the Reserve Bank from time to time.

- (e) Transfer of capital instruments where the non-resident acquirer proposes deferment of payment of the amount of consideration, prior approval of the Reserve Bank would be required, as hitherto. Further, in case approval is granted for a transaction, the same should be reported in Form FC-TRS, to an AD Category – I bank for necessary due diligence, within 60 days from the date of receipt of the full and final amount of consideration. The link office of the AD Category-I Bank will consolidate such Form FC-TRS details and report the same to the Central Office of RBI.

(ii) The transfer of capital instruments of companies engaged in sectors falling under the Government Route from residents to non-residents by way of sale or otherwise requires Government approval followed by permission from RBI.

(iii) A person resident in India, who intends to transfer any capital instrument, by way of gift to a person resident outside India, has to obtain prior approval from Reserve Bank. While forwarding applications to Reserve Bank for approval for transfer of capital instruments by way of gift, the specified documents should be enclosed. Reserve Bank considers the following factors while processing such applications:

- (a) The proposed transferee (donee) is eligible to hold such capital instruments under Schedules 1, 4 and 5 of Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time.
- (b) The gift does not exceed 5 per cent of the paid-up capital of the Indian company/each series of debentures/each mutual fund scheme.
- (c) The applicable sectoral cap limit in the Indian company is not breached.
- (d) The transferor (donor) and the proposed transferee (donee) are close relatives as defined in Section 6 of the Companies Act, 1956, as amended from time to time.
- (e) The value of capital instruments to be transferred together with any capital instruments already transferred by the transferor, as gift, to any person residing outside India does not exceed the rupee equivalent of USD 25,000 during the calendar year.
- (f) Such other conditions as stipulated by Reserve Bank in public interest from time to time.

Conversion of ECB/Lumpsum Fee/Royalty into Equity

(i) Indian companies have been granted general permission for conversion of External Commercial Borrowings (ECB) (excluding those deemed as ECB) in convertible foreign currency into shares/preference shares, subject to the following conditions and reporting requirements.

- (a) The activity of the company is covered under the Automatic Route for FDI or the company has obtained Government approval for foreign equity in the company;
- (b) The foreign equity after conversion of ECB into equity is within the sectoral cap, if any;

- (c) Pricing of shares is as per SEBI regulations or erstwhile CCI guidelines in the case of listed or unlisted companies respectively;
- (d) Compliance with the requirements prescribed under any other statute and regulation in force; and
- (e) The conversion facility is available for ECBs availed under the Automatic or Government Route and is applicable to ECBs, due for payment or not, as well as secured/unsecured loans availed from non-resident collaborators.

(ii) General permission is also available for issue of shares/preference shares against lump sum technical know-how fee, royalty, under automatic route or SIA/FIPB route, subject to pricing guidelines of SEBI/CCI and compliance with applicable tax laws.

REMITTANCE AND REPATRIATION

Remittance of sale proceeds:

Sale proceeds of shares and securities and their remittance is 'remittance of asset' governed by The Foreign Exchange Management (Remittance of Assets) Regulations 2000 under FEMA.

AD Category – I bank can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the security has been held on repatriation basis, the sale of security has been made in accordance with the prescribed guidelines and NOC/tax clearance certificate from the Income Tax Department has been produced.

Remittance on winding up/liquidation of Companies

AD Category – I banks have been allowed to remit winding up proceeds of companies in India, which are under liquidation, subject to payment of applicable taxes. Liquidation may be subject to any order issued by the court winding up the company or the official liquidator in case of voluntary winding up under the provisions of the Companies Act, 1956. AD Category – I banks shall allow the remittance provided the applicant submits:

- a. No objection or Tax clearance certificate from Income Tax Department for the remittance.
- b. Auditor's certificate confirming that all liabilities in India have been either fully paid or adequately provided for.
- c. Auditor's certificate to the effect that the winding up is in accordance with the provisions of the Companies Act, 1956.
- d. In case of winding up otherwise than by a court, an auditor's certificate to the effect that there are no legal proceedings pending in any court in India against the applicant or the company under liquidation and there is no legal impediment in permitting the remittance.

Repatriation of Dividend

Dividends are freely repatriable without any restrictions (net after Tax deduction at source or Dividend Distribution Tax, if any, as the case may be). The repatriation

is governed by the provisions of the Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amended from time to time.

Repatriation of Interest

Interest on fully, mandatorily and compulsorily convertible debentures is also freely repatriable without any restrictions (net of applicable taxes). The repatriation is governed by the provisions of the Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amended from time to time.

PROCEDURE FOR FOREIGN DIRECT INVESTMENT

Foreign Direct Investment in India is governed by FDI Policy issued by the Government of India and Foreign Exchange Management Act, 1999 and Rules and Regulation made thereunder. Foreign Direct Investments (FDI) can be made under two routes—Automatic Route and Government Route.

RBI has given permission to Indian Companies to accept investment under automatic route without obtaining prior approval from Reserve Bank of India. However, investors will have to file the required document with the concerned Regional Office of the RBI within 30 days after issue of shares to foreign investors.

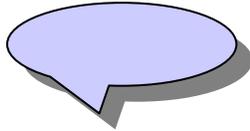
Under the Government Route

- The Minister of Finance who is in-charge of FIPB would consider the recommendations of FIPB on proposals with total foreign equity inflow of and below ₹1200 crore.
- The recommendations of FIPB on proposals with total foreign equity inflow of more than ₹ 1200 crore would be placed for consideration of CCEA. The FIPB Secretariat in DEA will process the recommendations of FIPB to obtain the approval of Minister of Finance and CCEA.
- The CCEA would also consider the proposals which may be referred to it by the FIPB/ the Minister of Finance (in-charge of FIPB).

Companies may not require fresh prior approval of the Government i.e. Minister in-charge of FIPB/CCEA for bringing in additional foreign investment into the same entity, in the following cases:

- Cases of entities whose activities had earlier required prior approval of FIPB/CCFI/CCEA and who had, accordingly, earlier obtained prior approval of FIPB/CCFI/CCEA for their initial foreign investment but subsequently such activities/sectors have been placed under automatic route;
- Cases of entities whose activities had sectoral caps earlier and who had, accordingly, earlier obtained prior approval of FIPB/CCFI/CCEA for their initial foreign investment but subsequently such caps were removed/increased and the activities placed under the automatic route; provided that such additional investment alongwith the initial/original investment does not exceed the sectoral caps; and
- The cases of additional foreign investment into the same entity where prior approval of FIPB/CCFI/CCEA had been obtained earlier for the initial/original foreign investment due to requirements of Press Note 18/1998 or Press Note 1 of 2005 and prior approval of the Government under the FDI policy is not required for any other reason/purpose.

Sector/Activity where FDI through Government Route are as under:



- *Defence Industries*
- *Asset Reconstruction Companies*
- *Terrestrial Broadcasting FM(FM Radio)*
- *Cable network*
- *Direct to Home Broadcasting*
- *Print Media*
- *Security Agency in Private Sector*
- *Banking- Public Sector*
- *Commodity Exchange*
- *Credit Information Companies*
- *Infrastructure Companies in Securities market.*

FOREIGN DIRECT INVESTMENT REPORTING

Reporting of Inflow

An Indian company receiving investment from outside India for issuing shares/convertible debentures/preference shares under the FDI Scheme, should report the details of the amount of consideration to the Regional Office concerned of the Reserve Bank not later than 30 days from the date of receipt in the Advance Reporting Form.

Indian companies are required to report the details of the receipt of the amount of consideration for issue of shares/convertible debentures, through an AD Category – I bank, together with a copy/ies of the FIRC/s evidencing the receipt of the remittance along with the KYC report on the non-resident investor from the overseas bank remitting the amount. The report would be acknowledged by the Regional Office concerned, which will allot a Unique Identification Number (UIN) for the amount reported.

Reporting of issue of shares

After issue of shares (including bonus and shares issued on rights basis and shares issued under ESOP)/fully, mandatorily and compulsorily convertible debentures/fully, mandatorily and compulsorily convertible preference shares, the Indian company has to file Form FC-GPR, not later than 30 days from the date of issue of shares.

Reporting of transfer of shares

Reporting of transfer of shares between residents and non-residents and vice-versa is to be done in Form FC-TRS. The Form FC-TRS should be submitted to the AD Category – I bank, within 60 days from the date of receipt of the amount of consideration. The onus of submission of the Form FC-TRS within the given timeframe would be on the transferor/transferee, resident in India. The AD Category – I bank, would forward the same to its link office. The link office would consolidate the Form FC-TRS and submit a monthly report to the Reserve Bank.

Reporting of Non-Cash

Details of issue of shares against conversion of ECB has to be reported to the Regional Office concerned of the RBI, as indicated below:

In case of full conversion of ECB into equity, the company shall report the conversion in Form FC-GPR to the Regional Office concerned of the Reserve Bank as well as in Form ECB-2 to the Department of Statistics and Information Management (DSIM), Reserve Bank of India, Bandra-Kurla Complex, Mumbai – 400 051, within seven working days from the close of month to which it relates. The words "ECB wholly converted to equity" shall be clearly indicated on top of the Form ECB-2. Once reported, filing of Form ECB-2 in the subsequent months is not necessary.

In case of partial conversion of ECB, the company shall report the converted portion in Form FC-GPR to the Regional Office concerned as well as in Form ECB-2 clearly differentiating the converted portion from the non-converted portion. The words "ECB partially converted to equity" shall be indicated on top of the Form ECB-2. In the subsequent months, the outstanding balance of ECB shall be reported in Form ECB-2 to DSIM.

Reporting of FCCB/ADR/GDR Issues

The Indian company issuing ADRs/GDRs has to furnish to the Reserve Bank, full details of such issue in the FORM DR, within 30 days from the date of closing of the issue.

The company should also furnish a quarterly return in the FORM DR-QUARTERLY, to the Reserve Bank within 15 days of the close of the calendar quarter. The quarterly return has to be submitted till the entire amount raised through ADR/GDR mechanism is either repatriated to India or utilized abroad as per the extant Reserve Bank guidelines.

Consequences of Violation

FDI is a capital account transaction and thus any violation of FDI regulations are covered by the penal provisions of the FEMA. Reserve Bank of India administers the FEMA and Directorate of Enforcement under the Ministry of Finance is the authority for the enforcement of FEMA. The Directorate takes up investigation in any contravention of FEMA.

Penalties

If a person violates/contravenes any FDI Regulations, by way of breach/non-

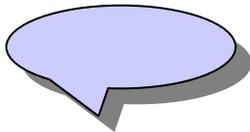
adherence/noncompliance/contravention of any rule, regulation, notification, press note, press release, circular, direction or order issued in exercise of the powers under FEMA or contravenes any conditions subject to which an authorization is issued by the Government of India/FIPB/Reserve Bank of India, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contraventions where such amount is quantifiable, or up to two lakh Rupees where the amount is not quantifiable, and where such contraventions is a continuing one, further penalty which may extend to five thousand Rupees for every day after the first day during which the contraventions continues.

Where a person committing a contravention of any provisions of this Act or of any rule, direction or order made there under is a company (company means any body corporate and includes a firm or other association of individuals as defined in the Companies Act), every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly.

Any Adjudicating Authority adjudging any contraventions may, if he thinks fit in addition to any penalty which he may impose for such contravention direct that any currency, security or any other money or property in respect of which the contravention has taken place shall be confiscated to the Central Government.

PROHIBITION ON INVESTMENT IN INDIA

FDI is prohibited in the following activities/sectors:



- *Retail Trading (except single brand product retailing)*
- *Atomic Energy*
- *Lottery Business including Government/private lottery, online lotteries, etc.*
- *Gambling and Betting*
- *Business of chit fund*
- *Nidhi company*
- *Trading in Transferable Development Rights (TDRs)*
- *Real Estate Business or Construction of Farm Houses*
- *Activities/sectors not opened to private sector investment.*

FOREIGN COLLABORATIONS AND JOINT VENTURES

One of the most common form of organisational strategic business relationship proliferating the worldover is the joint venture. The joint ventures utilize a separate

business entity to conduct the specified business activities. The use of a separate entity allows the parties to limit the liabilities associated with the relationship. More precisely, a joint venture is required in order for the parties to avail themselves of incentives and concessions offered under any local foreign investment programmes.

In essence, a joint venture arrangement consists of an agreement between two or more parties to combine, in a specific way, a certain kind or amount of their resources in order to manufacture, produce or sell a product or to render a service and share in a specified manner the profits that result and the risks that occur.

The rationale for joint venture varies from case to case according to the strategic business objectives and capacity of the individual partners, as well as external factors. They are often the means of acquiring raw materials, production facilities, technology or know-how. Most often, however, they are the means of expanding into new markets. Market access may, for instance, depend on linking up with established distribution channels or operating under a brand name already well recognised in the market place. The risks of operating in an unfamiliar jurisdiction, can be daunting, but the management of these risks can be enhanced by a joint venture with a compatible local partner familiar with local business practices, processes, procedures, laws and customs.

Foreign investment policies of many countries require or at least favour a minimum level of local participation. In some of the jurisdictions, foreign investors are required to allocate a preordained minimum share of the joint venture equity to the host government. A foreign investor can easily assess the real rate of return at the establishment stage of the venture. If, however, subsequent inputs of technology, services and capital by each of the partners are not based on impartial, arm's length market based calculations, the equilibrium of the Joint Venture is likely to become skewed and provide fertile ground for later differences.

JOINT VENTURE



A joint venture is an association of two or more individuals or business entities who combine and pool their respective expertise, financial resources, skills, experience, and knowledge in the furtherance of a particular project or undertaking. Joint Ventures are generally created for a single activity or project, and may have a limited time span. Joint Venture agreements, commonly referred to as a "JV", are typically formed either by individuals, business entities, corporations or partnerships. The contributions to the joint ventures are either in the form of money [capital], services, or physical asset(s), i.e. equipment or intellectual property [software, patents], etc., or a combination of all.

While similar in structure to a partnership, there are some very clear differences between the two structures, which should be clearly understood by the venturers before choosing this structure as a vehicle to carry on business. Of the many considerations involved in choosing the form of organization, the concern usually falls into the general categories of income taxation, administration and cost, and limitations on liability.

Like a partnership, it is usually seen that a joint venture sets out its business intentions in a written agreement, thereby setting the clear terms and conditions on business methods, sharing of revenues and expenses, and the manner in which the venture will cease. While this may end up incurring legal fees, the certainty that is created by a clear agreement and the lack of misunderstandings is a prudent cost at the start of business.

One common characteristic used to assert the proposition that a joint venture exists instead of a partnership is the “two-tiered structure” under which joint venture assets are usually leased from one of the venturers to the joint venture, which then uses those assets in the operation of the joint venture business.

MODES OF JOINT VENTURE

There are two fundamental types of joint venture, i.e., Equity Joint Venture and Contractual Joint Venture. Their description is as follows:

Equity Joint Venture

The equity joint venture is an arrangement whereby a separate legal entity is created in accordance with the agreement of two or more parties. The parties undertake to provide money or other resources as their contribution to the assets or other capital of that legal entity. The entity is generally established as a limited liability company and is distinct from either of the parties which participate in its creation. The newly created company, thus, becomes the owner of the resources contributed by the parties to the joint venture arrangement. Each of the parties in turn becomes the owner of the company having equity in the company.

The parties to a joint venture agreement agree on purposes and functions of the newly created entity, the proportion of capital contribution by each party and the share of each party in the profits of the company and on other matters such as its management, operation, duration and termination.

Contractual Joint Venture

The contractual joint venture might be used where the establishment of a separate legal entity is not needed or the creation of such a separate legal entity is not feasible in view of one or the other reasons. The contractual joint venture agreement can be entered into in situations where the project involves a narrow task or a limited activity or is for a limited term or where the laws of the host country do not permit the ownership of property by foreign citizens. For the purposes of contractual joint venture, the relationship between parties is set forth in the contract or agreement concluded between them.

Whether one or more of the legal methods are used in the establishment of the joint venture company to carry out its operations is always based on the negotiations between the parties, the results of which reflect in the joint venture agreement entered into between the parties. The licensing agreement, know-how agreement, technical services or technical assistance agreement, franchise agreement and agreement covering all other commercial matters might even form annexes to the main joint venture agreement. They can be signed once the joint venture company is established.

It is important to note that a joint venture agreement, be it for the establishment of a limited liability company or not, and the different contracts must be concluded in accordance with laws and regulations applicable to such companies including tax laws concerning these companies or the laws relating to agency or partnership as well as other economic laws, in addition to laws relating to labour, sales of goods, insurance and foreign economic and trade contracts.

Negotiating a Joint Venture Agreement

Setting up and operation of a joint venture company, consequent on agreement between the parties, involve various issues and may require sizeable time of the parties concerned. The issues having bearing on the durability of joint venture and those requiring special attention in drafting the various provisions of the agreement need careful negotiations. Such issues may include purpose of the joint venture, contributions by the parties, capital structure and further issue of capital, management, control and administration and duration, continuity and termination of joint venture and other operational issues.

Purpose of Joint Venture

A well defined objective is one of the most important and crucial issues in the joint venture agreement. The parties should arrive at some understanding to identify and define in clear terms the basic purposes of the proposed joint venture. Therefore in identifying and defining the basic objectives of the proposed joint venture company, the parties must take into account the scope and size of joint venture business, management and operational responsibilities of parties, decision making process, terms of any ancillary agreement between joint venture and either of the parties etc.

Contributions by Parties

While planning and negotiating the proportion of contributions to be made by the parties in the proposed enterprise, the issues relating to financial, technical and functional requirements of the joint venture throughout the proposed term of its existence must be discussed and analysed threadbare. Since the parties are something more than passive investors in the joint venture, the range of possible contributions are much broader than is normally required. For instance, not only will the parties contribute cash and cash equivalents to finance the operations of the joint venture, they may also provide the venture with services, tangible and intangible property rights and specific functional expertise in such areas as research and development, manufacturing and distribution. In addition, parties may be able to contribute their experience and contacts in dealing with local regulators and in obtaining supplies of scarce raw material.

Capital Structure

The capital structure is an essential element of a business venture. Therefore, the issues relating to capital structure should be clearly defined in the joint venture agreement, so as to avoid any dispute between the parties concerning return on invested capital, management, control and administration of the enterprise. As the parties become the owner of the enterprise on its formation, they acquire such rights

as may be created under the laws of the host country as well as any contractual agreement between the parties.

Management, Control and Administration

Devising an appropriate governance structure for a joint venture company is of critical importance to the success, growth and development of that company. While discussing similar issues relating to joint venture, Allen Gutterman & Robert Brown in Commercial Laws of East Asia exemplified as follows:

“Assuming that the choice is made to utilize the corporate form of business entity, the parties must consider various issues relating to the election of board of directors, the selection of the officers and key managers, the respective voting rights of each party on matters deemed to be material to the board of directors, the officers and any committees created by the parties to manage one or more of the business functions of the enterprise. Also, while hopefully the parties will not reach a situation where they are unable to agree on certain matters, the parties should agree upon a procedure for the orderly resolution of disputes”.

It is in this connection very common for companies to enter into contract with one or more of the parties to conduct some specific functions and services including even basic research and development, manufacturing and distribution, thus as a consequence to these agreements, the party(ies) effectively assume control over operations of the enterprise, even though the nominal authority rests with the board of directors and managers of the companies. Therefore, to avert such happenings in the management and administration of joint venture, the parties must strike a balance between the powers and right of parties and the board of directors. As the joint venture companies are an independent legal entity with life of its own, it is of great importance to the parties to include in joint venture agreement key issues relating to operation of enterprise, such as legal compliances, insurance, disclosure of information, accounting and financial reporting including allocation and distribution of joint venture income.

Continuity of Joint Venture

The Joint Venture Agreement is an agreement in perpetuity. It lasts so long as the parties to the Joint Venture continue to be in business. However, situations may arise when one of the parties want to pull out of joint venture arrangement. In such cases, the outgoing party will have to make a first option of purchase of its interest to the other party to the Joint Venture. If this fails, the outgoing partner will have the option of bringing a new party to the Joint Venture in which case all the provisions of the Joint Venture agreement will apply to the new party, as if the new party had been a signatory to the Joint Venture agreement.

Issue of Further Capital

Another crucial issue in a Joint Venture is the issue of further capital by the Joint Venture company. In order to maintain the proportion of capital contributed by the parties to the Joint Venture, further issue of capital is strictly regulated, subject to unanimous consent of the entire Board of directors and not by majority decision.

Operational Issues

Besides issue of further capital, a number of other operational issues like borrowing of monies, expansion and diversification of business of joint venture dividend policy, investment by the joint venture in the purchase of shares of other companies etc. are crucial in respect of which the articles of association of the joint venture company provides for unanimous consent of the Board, in which the joint venture parties are represented ,proportionate to their voting strength.

These are some of the issues which need to be properly and adequately dealt with by the parties while negotiating a Joint Venture agreement.

DRAFTING JOINT VENTURE AND FOREIGN COLLABORATION AGREEMENTS

International business professionals use the term “modes of entry” to describe the different methods and approaches available to enter markets and conduct business in other countries. One mode of entry is the joint venture where two or more organizations join together in a cooperative effort to further their business goals. The joint venture is one of the most common and effective means of conducting business internationally. The joint venture documents and agreements are critical to the success of the venture. The joint venture agreement forms the basis of the understanding between and among the parties. It is relied upon to ensure that all parties understand their roles, rights, responsibilities, and remedies in the conduct of the venture. Organizations enter into joint ventures in good faith but closely scrutinize the joint venture documents if anything goes awry.

The importance of the documents and the purpose of this part is to cover, step by step, the critical elements to consider and include in joint venture agreements. Equity participation, for example, may or may not be as important as operational control. Technical participation in the venture may or may not be as important as the intellectual property rights that may result from the venture. A key to developing joint venture agreements is to determine goals and objectives in advance and ensure that the interests are reflected in the agreement.

Selection of a good local partner is the key to the success of any joint venture. Personal interviews with a prospective joint venture partner should be supplemented with proper due diligence. Once a partner is selected generally the parties highlighting the basis of the future joint venture agreement sign a memorandum of understanding or a letter of intent. Before signing the joint venture agreement, the terms should be thoroughly discussed to avoid any misunderstanding at a later stage. Negotiations require an understanding of the cultural and legal background of the parties.

DRAFTING AN AGREEMENT

It is difficult to prepare a set frame of the terms and conditions. The conditions may differ according to the requirements. While drafting a foreign collaboration agreement, the following factors should be kept in mind:

- Capability of the collaborator and the requirements of the party are clearly indicated.

- Clear definitions of technical terms are given.
- Specify if the product shall be manufactured/sold on exclusive or non-exclusive basis.
- Terms and conditions regarding nature of technical know-how, disclosure of drawings, specifications and other documents, furnishing of technical information in respect of processes with flow charts etc., plant outlay list of equipment, machinery and tool with specification have to be provided.
- Provisions for making available the engineers and/or skilled workers of the collaborator on payment of expenses relating to their stay per diem etc. are given.
- Details regarding specification and quality of the product to be manufactured are given.
- Quality control and trademarks to be used are also specified.
- Responsibility of the collaborator in establishing or maintaining assembly plants should be clearly determined and provided for.
- If sub-contracting of the work is involved, clarify if there would be any restrictions.
- The rate of royalty, mode of calculation and payment etc. Also, make provision as to who will bear the taxes/cess on such payments.
- Use of information and industrial property rights should also be provided for in the agreement.
- A clause on force majeure should be included.
- A clause that the collaborating company has to train the personnel of Indian company within a specified period should be incorporated. The clause should also specify the terms and conditions of such assistance, place of training, period of training and fees payable.
- A comprehensive clause on arbitration containing a clear provision as to the kind of arbitrator and place of arbitration should be included.
- There should be provision in the agreement for payment of interest on delayed payments.

IMPORTANT CLAUSES IN COLLABORATION AGREEMENTS

The collaboration agreement should generally contain the following comprehensive clauses:

(1) In case of agreement for provision of technical know-how

- definition and characteristics of the subject-matter of the know-how;
- the mode of transfer of technical know-how i.e. the time and place of transfer and whether the transfer is absolute or for a specified period;
- clause safeguarding secrecy of the technology;

- training of the technical personnel of the Indian company by the foreign collaborator;
- performance guarantee in regard to the achievement of the required qualities, standard of the product, quantities to be produced and minimum standard of performance with suitable indemnity clause;
- conferring of licence or patent right for the technical know-how and the product to be manufactured;
- mode and method of payment i.e. whether a lump-sum or by way of royalty or technical fees;
- who would own the future improvements in the technology by the transferee made by the transferor of the technology;

(2) In case of agreement for a joint venture

- since in India a foreign company is not allowed (except in exceptional circumstances) to hold more than 51% shares in any company in India, care must be taken to provide for the equity participation by the foreign company under a joint venture agreement; the agreement should also provide for the type of share capital and the mode of payment for acquiring the shares;
- the constitution of the Board of Directors with election, number of directors and the powers of the Board;
 - who will run the management of the company, and
 - pre-emption rights on the shares of the company.
- the mode of declaration and distribution of the dividends;
- the area of marketing of the products;
- restriction on any change in the ownership ratio; other provisions as incorporated under an agreement for supply of technical know-how.

ARBITRATION CLAUSE

The drafting of an arbitration clause appears straightforward, but there are a number of matters which should be considered. Each of the arbitration institutions referred earlier recommends a form of wording. Given below are the clauses recommended by the ICC, the LCIA and the ICA, together with an example of an *ad hoc* clause.

A. ICC Recommended Arbitration Clause

“All disputes arising in connection with the present contract shall be finally settled under the Rules of Conciliation and Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules.

Parties are reminded that it may be desirable for them to stipulate in the arbitration clause itself the law governing the contract, the number of arbitrators and the place and language of the arbitration. The parties’ free choice of the law governing the contract and of the place and language of the arbitration is not limited by the ICC Rules of Arbitration.

Attention is called to the fact that the laws of certain countries require that parties to contracts expressly accept arbitration clauses, sometimes in a precise and particular manner”.

B. ICA Recommended Arbitration Clause

“All disputes or differences whatsoever arising between the parties out of or relating to the construction, meaning and operation or effect of this contract or the breach thereof shall be settled by arbitration in accordance with the Rules of Arbitration of the Indian Council of Arbitration.”

C. Example of Indian Collateral Agreement

“All disputes and differences arising out of or in relation to the contract dated..... entered into by the parties hereto, and all or any questions concerning the existence and/or validity of the said contract (or any of its terms) shall be referred to and settled by arbitration in accordance with the Rules of Arbitration of”

D. LCIA Recommended Arbitration Clause

Parties to an international contract who wish to have any disputes referred to arbitration under the LCIA Rules are recommended to insert in the contract an arbitration clause in the following form:

“Any dispute arising out of or in connection with his contract, including any question regarding its existence, validity or termination, shall be referred to and finally resolved by arbitration under the Rules of the London Court of International Arbitration, which Rules are deemed to be incorporated by reference into this clause”.

Parties are also reminded that difficulties and expenses may be avoided if they expressly specify the law governing their contract. The parties may if they wish also specify the number of arbitrators, and the place and language of the arbitration. The following provisions may be suitable:

“The governing law of this contract shall be the substantive law of.....”

“The tribunal shall consist of(a sole or three) arbitrator(s).”

In the case of a three-member tribunal, the following words may be added

“...two of them be nominated by the respective parties”

“The place of the arbitration shall be(city)”

“The language of the arbitration shall be”

E. Example of an ad hoc Arbitration Clause

“Any dispute, controversy or claim arising out of or in relation to this contract or its breach, termination or invalidity shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules, and the appointing authority shall at the time be the President of the Indian Chamber of Commerce”.

SPECIMEN AGREEMENT FOR FOREIGN TECHNICAL SERVICES IN INDIA

THIS AGREEMENT made today ofBETWEEN..... — a company registered in India under the Companies Act 1956 having its registered office at..... (hereinafter referred to as the Indian Company) which expression shall, unless repugnant to the context or meaning thereof, be deemed to include its successors and assigns of the ONE PART AND..... — a German corporation, with place of registry in and having an office at.....(hereinafter referred to as the Foreign Company) which expression shall, unless repugnant to the context or meaning thereof, be deemed to include its successors and assigns of the OTHER PART.

WHEREAS—

1. The Indian Company intends to establish a self-sufficient and well-equipped industrial unit in India for the purpose of developing, manufacturing and marketing of the products, fully described and specified in the Schedule-A hitherto (hereinafter referred to as the said products).

2. The Indian company has obtained necessary Licence from the Government of India for an initial production capacity of 1 per year subject to the terms and conditions specified in the said Licence.

3. The Foreign Company has for many years in past been carrying on manufacture, marketing, sale and distribution of the said product in and has acquired considerably technical skill and expertise in the field of this business.

4. The Foreign Company, by virtue of its specialisation in the field of this business, is in possession of extensive technical know-how concerning the setting up of a modern manufacturing unit for the manufacture of the said products in India or elsewhere and has at its disposal sufficient skilled technical personnel to provide technical assistance in the nature of consultancy, advisory and operating services to the Indian Company.

5. The Indian Company is desirous of acquiring from the Foreign Company the said specialised services in the nature of consultancy, advisory and operating services in the matter of settling up of a new manufacturing unit for the Indian Company in India.

6. The Foreign Company has agreed to provide the said technical assistance by way of consultancy, advisory and operating services for setting up of a new self-sufficient unit for the purpose of manufacturing, marketing, sale and distribution of the said products in India by the Indian Company upon the terms, conditions and stipulations set forth herein.

NOW THIS AGREEMENT WITNESSETH and it is hereby agreed by and between the parties as follows:

1. Technical Services

The Foreign Company shall render the following technical services to the Indian Company:

- (i) Feasibility study for the proposed project, including market survey,

profitability, cash flow projections and preparation of comprehensive project report.

- (ii) Provide manufacturing/engineering technology available with the Foreign Company relating to design, production method, manufacture and testing of the said products, to the Indian Company.
- (iii) Explore for adaptation of the requisite local technology, expertise and skill.
- (iv) Assist in the manufacture and development of the said products according to the required standard and technology.
- (v) Assist in regular research and quality control of the raw materials and the finished products and to explore suitable substitutes acceptable to customers.
- (vi) Advise proper marketing, selling and distribution techniques appropriate for the said products.
- (vii) Assist and advice in the procurement of appropriate raw materials and explore and advice suitable import substitutes.
- (viii) Advise production-planning appropriate for optimum utilization of the rated production-capacity maintaining plant and machinery for the manufacture of the said products to the required standard.
- (ix) Assist and advice in setting up ancillary small and medium scale industries for the growth and development of the Indian Company's factory.
- (x) Advise introduction of operation and maintenance system suitable for the plants and machineries to be used in the manufacturing process to ensure safe and efficient normal life.
- (xi) To assist and advice appropriate safety measures and appropriate appliances to comply with the statutory requirements and otherwise.
- (xii) To assist in the preparation of a list of – maintenance spares required for various plants and machineries to be used in the factory.
- (xiii) To assist in the cost and budgetary control.
- (xiv) To assist in conducting constant market research and advice change in the product-design or sales engineering according to the changed demand of the customers.

2. Deputation of technical personnel

- (i) It is understood and agreed that the Foreign Company shall provide technical services hereunder by and through its own technical personnel or by and through any of the Foreign Company's associate company acceptable to the Indian Company.
- (ii) The Foreign Company shall depute from its trained technical personnel such number of staff not exceedingemployees as and when required by the Indian Company to assist the Indian Company in setting up of the proposed manufacturing unit and its running and maintenance.
- (iii) Besides the technical services enumerated in clause 1 hereof, the technical

personnel deputed by the Foreign Company shall also be responsible for rendering the following services:

- (a) Making periodical site inspection of and during the construction of the factory at the cost and expenses of the Indian Company, as may be necessary and also to cause periodical checking whether the factory is being constructed by the Indian Company in compliance with the instructions, specifications and standards supplied by Foreign Company.
- (b) Assisting in the procurement of the required plant, machinery and equipment for the proposed factory from appropriate sources and inspecting the same at the supplies premises before they are supplied to ensure their correctness and standard.
- (c) Holding conference with engineers, contractors, specialists and architects from time to time to advise the Indian Company upon the techno-commercial supervision of the factory in order to ensure maintenance of the factory according to the standard and technical specifications laid down by the Foreign Company.
- (iv) The technical personnel so deputed by the Foreign Company shall remain employees of the Foreign Company but while working in the factory of the Indian company they shall be subject to all the rules and regulations of the Indian Company as applicable to their employees.

3. Training of personnel of the Indian Company

- (i) During the term of this agreement the Foreign Company shall undertake from time to time to train personnel of the Indian Company for training in its plant in
- (ii) The training shall be for such period and for such number of personnel as may from time to time be mutually agreed upon by the parties.
- (iii) The Foreign Company ensures that the training of the personnel of the Indian Company as may be imparted shall be adequate to impart complete competency in the respective fields for independent performance of the required functions for the Indian Company.
- (iv) The Indian Company shall obtain prior approval of the Government, wherever necessary, for the purpose of deputation of their personnel for the training abroad to the Foreign Company.
- (v) The Indian Company shall be responsible for and bear all expenses incidental to such training of their personnel, provided that no additional charges shall be payable by the Indian Company to the Foreign Company for importing such training to the personnel of the Indian Company.
- (vi) The personnel of the Indian Company shall during the period of their training observe all the rules and regulations as applicable to the employees of the Foreign Company.

4. Secrecy

- (i) It is hereby agreed and declared that all written advises and materials and

all drawings, documents, specifications and technical know-how under this agreement in pursuance of the technical services to be rendered by the Foreign Company to the Indian Company shall be held in strict confidence and secrecy and shall not be disclosed by the Indian Company or any of its employee without written prior permission of the Foreign Company during the term of this agreement to any third party.

- (ii) In the event of termination of this agreement on account of any default whatsoever by the Indian Company, all such documents and materials shall be returned by the Indian Company to the Foreign Company.

5. Consideration

In consideration of the Technical Services to be rendered by the Foreign Company to the Indian Company under this agreement, the Indian Company shall pay the following Technical Services fee to the Foreign Company:

- (i) For the first 3 years from the date of commercial production a sum of ₹(Rupees.....) only per annum is payable half yearly within seven days from the last day of the preceding month.
- (ii) For the next 2 years thereafter, a sum of Rs.....(Rupees.....only) per annum is payable in the above manner.
- (iii) All such payments shall be payable by the Indian Company to the Foreign Company in thecurrency, subject to Indian taxes, at the Registered Office of the Foreign Company through normal banking channels.

6. Prior Government approval

This agreement shall be subject to the prior approval being obtained by the Indian Company and the Foreign Company from the appropriate authorities in their respective countries in respect of the transaction herein contemplated, such approval being obtained within 12 months from the date hereof and in the event such approval not being obtained with the said period of 12 months by either party, the other shall have the right to rescind this agreement. In the event such approval is obtained within the said period the effective date of this agreement shall be construed as the date on which this agreement has been taken on record by the Government for the purpose of such approval.

7. Duration of the agreement

- (i) This agreement shall come into force on and from the "effective date" defined in clause 6 hereinabove and shall remain in force for a period of five years therefrom or five years from the date of the commencement of regular commercial production of the said products, whichever is later, provided such production is not delayed beyond three years from the "effective date" of this agreement.
- (ii) Subject to the approval of the appropriate Government authorities, this agreement may be renewed in whole or in part for a further period by mutual agreement, provided negotiations for extension shall be taken up one year prior to the expiry of the term of this agreement.

- (iii) This agreement shall be binding upon and inure to the benefit of the successors and assigns of the respective parties hereto, and the obligations hereunder shall not be assignable by the either party without the consent in writing being first obtained from the other.

8. Termination of the agreement

Notwithstanding anything contained herein, either party may by notice in writing to the other party terminate this agreement under any one of the following conditions

- (i) If the Foreign Company fail to perform or observe any of its obligations under this agreement which it is obliged to perform or observe hereunder.
- (ii) If either party discontinue business or be adjudicated insolvent or bankrupt or make an assignment for the benefit of creditors or a composition with creditors or shall file a voluntary petition of winding up or shall answer admitting the material allegations of an involuntary petition pursuant to any applicable law of any jurisdiction or if any order is entered appointing a receiver or trustee of either party or of a substantial portion of assets of either party or if either party applied for a consent to the appointment of such receiver or trustee.
- (iii) If there is a change in the existing management and/or constitution of the business of the Indian Company whether through the alienation of shares, or through the increase of capital and the issue of new shares, or otherwise howsoever, unless the matters and effects arising out of such change are remedied and mutually settled by a written instrument by the parties hereto within 90 days from the date when such change first occurs.
- (iv) If at any time during the term of this agreement either of the parties hereto fails to perform its respective obligations hereunder, the other party shall have the right to terminate this agreement by giving 90 days' notice in writing setting forth the breach of obligation under this agreement complained of and unless the breach is cured within 30 days from the date of such notice, the agreement shall be terminated on the expiry of 90 days and the rights of the parties hereunder shall cease upon the date so specified in the notice.
- (v) Upon the termination of this agreement for any reason whatsoever, all amount due and owing as between the parties shall become due and be paid within 30 days from the date of termination of this agreement.

9. Force Majeure

No party to this agreement shall be responsible for any failure or delay on its part in performing any of its obligations or for any loss, damages, costs, charges or expenses incurred or suffered by the other party by reason of such failure or delay if such failure or delay is caused due to any force majeure conditions, such as acts of God, Government laws and regulations, strikes, Lockouts, war or any other causes beyond its control.

10. Arbitration

In case of any dispute or difference arising between the parties hereto or any

claim or thing herein contained or the construction thereof or as to any matter in any way connected with or arising out of these presents or the operation thereof the rights, duties or liabilities of either party thereof, then and in every such case the matter, differences and dispute shall be referred to an arbitrator in India in case parties agree upon one, otherwise two arbitrators in India, one being nominated by each party to this agreement in accordance with and subject to the provisions of the Arbitration and Conciliation Act, 1996, or any other enactment or statutory modifications thereof for the time being in force.

11. Miscellaneous

- (i) This agreement, either whole or in part, or any rights given hereunder cannot be assigned or transferred in any manner whatsoever by either party without the prior written consent of the other party.
- (ii) This agreement cannot be altered or modified otherwise than by a written instrument duly signed by both the parties.
- (iii) Any notice required to be given under this agreement shall be in writing and sent by post addressed to either of the parties at their Registered addresses.

12. Law applicable

This agreement shall be construed in accordance with and be governed by the laws of India.

IN WITNESS WHEREOF the parties hereto have hereunto caused their respective Common Seal to be hereunto affixed the day, month and the year first above written.

Signed Sealed and Delivered by (FIRST PARTY) the Common Seal of Company was hereunto affixed pursuant to a resolution of its Board of Directors passed in that behalf onin the presence of Mr..... its Secretary who have signed in the presence of

Signed Sealed and Delivered by (SECOND PARTY) the Common Seal etc.

RESTRICTIVE CLAUSES UNDER FOREIGN COLLABORATION/JOINT VENTURE AGREEMENTS

The term restrictive practice signifies non-governmental measures used by the companies to strengthen their position in a given market. These practices can hamper or distort international trade, which often coincides with the public interest of the country concerned. Two conceptual approaches have been applied for the purpose of control and prevention of restrictive practices in the foreign collaborations as well as technology transfer arrangements. In developed market economy countries, the control of restrictive business practices are governed by the rules based on competition and anti-trust laws. These laws prohibit restrictive business practices when they distort or prevent competition. Such legislations are primarily concerned with the direct or indirect effects of restrictive business practices on the domestic market. The developing countries have enacted regulations on transfer of technology which deal with restrictive business practices on the basis of a conceptual

approach which, though not necessarily incompatible with anti-trust or competition laws, but substantially differs from it.

The main object of such an approach is to protect certain wider interests which are closely related to the economic and technological development of the recipient country. The approach adopted by the developing countries seeks to prohibit any practice that establishes a relationship of dependence or control over the productive, technological or marketing activities of the recipient country or any other practices which adversely affect the economy and development policies of the recipient country.

The concept of unfair competition has been also recognised under the Paris Convention which comprises not only infringement of industrial property but also all other acts which adversely affect the business relations of a person. The provisions of the Paris Convention contain a broad stipulation that any act of competition contrary to honest practices constitute an act of unfair competition. These provisions affirm the foundation of fair competition as being honest practices or good morals and set out three kinds of acts which are deemed typically unlawful in international trade and therefore, must be prohibited.

'Honest practice' is the term used in Article 10 bis of the Paris Convention and in the legislative Acts of a number of countries. It is a notion equivalent in effect to the term *Jute Sitten* of the German Law and *Correttezza professionale* in the Italian law. UNCTAD Code of Conduct on Transfer of Technology under Chapter IV has also recognised some practices as restrictive practices. The Monopolies and Restrictive Trade Practices Act, 1969 and the Patents Act, 1970 in India also prohibit the use of restrictive practices in Foreign Collaboration and Technology Transfer agreements.

KINDS OF RESTRICTIVE PRACTICES

Following are some of the restrictive practices being used in the foreign collaboration and technology transfer agreements.

Restrictions after expiration of Industrial Property Rights or Loss of Secrecy of Technical Know-how

The expiration of the term of patent in a technology transfer agreement signifies that the knowledge and invention covered by such patent enters into public domain and any interested party can use such patent without any obligation. Therefore, any restriction or future payment or any other obligations in respect of such an industrial property rights should be invalid. Where the supplier of the technology imposes any restriction after the expiration of the intellectual property rights, such restriction is deemed to be the restrictive practice.

The real problem arises in the case of package licensing, where the restrictions or payment obligations are artificially prolonged beyond the life time of the main patent by referring to the expiry of the last improvement patent or by basing restrictions on patents actually not exploited by the licensee. The problem may also arise when the secret know-how loses its secret character before the expiration of the agreement. Here it is necessary to consider that whether the restrictions and payment obligations as contained in the agreement should be honoured by the

recipient company. In this regard, the approaches adopted by the national laws varied considerably. Some countries consider only those restrictions and payment obligations to be unlawful where the restrictions and payment obligations are based on the secrecy of the know-how. While the other countries prohibit any restriction on the free use of transferred technology once the specified period of time after the transmission of the know-how has passed, even when the know-how has not yet lost its secret character.

Restrictions after Expiration of Arrangements

The use of such clauses in technology transfer agreements generally oblige the company acquiring technology to pay royalties during the entire duration of manufacture of product or the application of the process involved, without specifying any time limit. Sometimes these clauses also contain restrictions to be continued even after the expiration of the agreement, for example, restrictions on competition, restriction on Research and development activities and specially, the acquiring company's obligation to keep secret and not to make use of the confidential information even after the expiration of the life of the arrangement.

UNCTAD Code also prohibits the restrictions after the expiration of arrangements but this provision is still to be negotiated because the developing countries are of the view that no restriction should be allowed if the know-how has lost its secret character. Whereas the developed and socialist countries want these restrictions to be allowed if the technology is still legally protected, or has not entered the public domain.

Restrictions on Research and Development

Such restrictions in the technology transfer agreement generally involve limitations on the research and development policies and activities of the company acquiring technology.

The use of such clauses affects directly or indirectly the possibilities for the technological development capabilities of the recipient company. Such provisions also restrict the freedom of recipient party to undertake its own Research and development programmes. These restrictions also cover such provisions which are in direct competition with Research and Development activities of the company supplying technology.

In India, the entrepreneurs are advised to incorporate, in negotiating collaboration agreements, suitable provisions for the training and adequate arrangements for Research and Development, engineering designs, training of technological personnel and other measures for the absorption, adaptation and development of imported technology.

The restrictions on Research and Development activities of recipient company have also been declared as restrictive practices under the UNCTAD Code. The provisions recognised such clauses as restricting the acquiring party from undertaking R&D activities directly to absorb and adapt the transferred technology to suit local conditions or restriction on initiation of R&D programmes in connection with new products, processes or equipment.

Non-Competition Clauses

The Non-competition clauses in the technology transfer transactions include the restrictions on freedom of technology acquiring company to enter into arrangements to use or purchase the competing technologies or products not furnished or designated by the company supplying technology. These clauses directly or indirectly affect the acquiring company's capability of competition. Some of the non-competition clauses which may have direct effect, oblige the recipient company not to manufacture or sell competing products or not to acquire competing technology. Non-competition clauses which may have indirect effect, oblige the recipient party not to cooperate with competing enterprises or to pay higher royalties if it sells or manufactures competing products.

In India the MRTP Act makes every agreement subject to registration if it contains provisions restricting the employment of any method, machinery or process in the manufacture of goods. Similarly (Indian) Patents Act, 1970 also declares an agreement unlawful if it restricts the purchaser, lessee or licensee, in any manner or to any extent, from using any process other than patented process. UNCTAD Code also prohibits the use of restrictions on the freedom of the acquiring company to enter into agreements relating to similar or competing technologies or products or to obtain competing technology.

Tying Arrangements

Tying clauses in a technology transfer agreement requires the licensee to obtain raw materials, spare parts, intermediate products for use with licensed technology, only from the licensor or its nominees. These clauses also oblige the acquiring company to use personnel designated by the supplier.

The main reason behind the use of tying clauses by the company supplying technology seems to be based on the fact that it wants to preserve an exclusive right to supply necessary processed or semi-processed inputs, to maintain quality control, and to expand their profit margin.

The tying clauses generally result in a monopoly control of the supply of equipment and other inputs by supplying enterprises, leading to "transfer pricing", "transfer accounting" or "uneconomic output". By virtue of this exclusive position, the supplier company charges higher price than for comparable equipment and other inputs that could otherwise be obtained elsewhere. The use of tying clauses not only affects production costs through the overpricing of inputs but may have important indirect effect on the import substitution, export diversification and growth efforts of the technology acquiring company.

Export Restrictions

Export restrictions in a transfer of technology agreement may include clauses restricting or prohibiting the export of products manufactured by the transferred technology. These clauses restrict the export of such products to certain markets or permission to export to certain markets and requirement of previous permission for exports. The restrictions can be classified into following three categories:

Direct Restrictions

The restrictions having direct impact involve complete restriction on the export of

products. In some cases the supplier company imposes restrictions on acquiring company as to prohibit or permit the export to one or more specified countries or areas. These restrictions may also include prohibition or permission to export only specified goods. Export quota also comes under the purview of direct export restrictions.

Indirect Restrictions

Indirect restrictions cover very wide range of restrictions. Amongst others, the important indirect restrictions are the prior approval of supplier to export the goods manufactured by the imported technology, including the requirement of primary responsibility for the domestic market or higher royalties on output designated for export. Such restrictions also require the recipient party to export its product on predetermined prices or quality control. In some other cases obligations are imposed to sell its product exclusively to the supplier company or to export only through supplier or designated agents.

Implied Restrictions

There may be some clauses which neither fall under the category of direct nor indirect restrictions, but are treated as restrictive business practices as they have the potential of affecting export by acquiring company. The implied restrictions generally relate to the operations of Multinational Corporations (MNCs), these Corporations have their equity and management control over their subsidiaries and affiliates abroad and by virtue of such control they are able to effect the market restrictions quite easily.

The adverse impact of export restrictions have received considerable attention in the various reports of the United Nations Conference on Trade and Developments (UNCTAD) on the subject Export restrictions in technology transfer agreements give rise to an artificial anti-competitive market allocation which may result as distortion in the pattern of international trade and distribution of benefits from trade between countries. The impact of such restrictions may be summarised as follows:

- (i) It may totally or partially block actual or potential export possibilities of recipient company.
- (ii) It may prevent the acquisition of marketing skills, which might lead to continued dependence on few multinational corporations or distributor cartels which control international market channels.
- (iii) It may limit the benefits which are to be derived from the application of the generalised system of preferences.
- (iv) It may also hamper the efforts at regional economic cooperation.

Additionally, the evidence available suggests that export restrictions tend to be not very significant in some of the traditional industries, such as primary processing, as compared to import substituting or modern research-intensive industries, for example, chemicals and pharmaceuticals, which are potentially more dynamic and can offer greater prospects for export-based industrialisation. Apart from the more easily identifiable effects of export restrictions, they may have several indirect effects such as to raise the unit price of a product to consumers because of their effects on capacity utilization in the industry, since the attainment of economies of scale may be impeded as a result of limitations on output.

In India, the restrictions are acceptable where the foreign collaborator has existing licensing arrangement for manufacture but in such cases the foreign collaborator is under an obligation to specify the countries concerned for export franchise on exclusive or non-exclusive basis, as the parties to the agreement may agree.

In this connection it is necessary to point out that the UNCTAD Code have also recognised 'export restrictions' as restrictive practices. The draft text allows export restrictions to be included in the areas where the supplier has industrial property right or where the supplier has granted an exclusive licence to use the relevant technology or a specific option has firmly or expressly been secured.

Price Fixing

Price fixing clauses in a technology transfer arrangement involve the practices where the supplier company reserve the right to fix the sale or resale price of the product manufactured by the imported technology. In certain cases the imposition of resale conditions might be justified, e.g. where the supplier company practices a legal selective distribution system, the supplier may impose the conditions on his distributor only to sell to qualified dealers. Therefore, the price-fixing clauses may cover the price determined by the supplier on goods produced with the help of transferred technology. Price-fixing may also involve horizontal price cartels between several technology suppliers or several technology recipients.

Restrictions on Field of Use, Volume or Territory

Restrictions on the field of use authorises supplier company to restrict use of the technology or reserving some uses of technology for self-exploitation or exploitation by third parties. The practices concerning the volume restrictions may consist of minimum production requirements or maximum output. The volume of production may also be controlled by higher royalties to be paid beyond a certain production quota or to produce by manufactured goods in a prescribed package with a certain weight. Therefore, such type of restrictions on the production may prevent the recipient company from producing enough for export. In some cases the restrictions may be included for the purpose of avoiding over-production by enabling both, the supplier and the recipient, to maintain a certain price level to the disadvantage of the consumer.

The volume restrictions are generally used by the supplier company to preserve its competitive position in a given market. Moreover, where the protected technology covers manufacturing rather than product itself, the recipient's capability to compete in world market with the transferred technology may actually be hindered by the volume restrictions.

Grant-back Provisions

The grant-back provisions in the technology transfer transactions provides for flow of technical information and improvements to the supplier. These provisions oblige the recipient company to transfer to the supplier of technology, free of cost, any invention or improvement made in the imported technology. The grant-back provisions may be characterised as 'unilateral', 'exclusive or non-exclusive'. A

unilateral grant-back provision establishes unilateral flow of technical information or improvement by recipient without any reciprocal obligation of the supplier company. Therefore, such provisions oblige the technology recipient company, to provide to the supplier all future improvements made in the technology, on unilateral basis. While in the case of an exclusive grant back clause, though the recipient company may freely use the invention and improvement developed by it, yet the recipient is not free to transfer or licence the same to the third party. Such clauses restrict the right of the recipient company to licence or transfer the invention developed through its own R&D activities.

The main reason behind the inclusion of grant-back provision appears to be rooted in the free of cost grant-back. Generally, the grant-back is not remunerated and thus, supplier company has advantage of securing access to all improvements made by the recipient. In this situation, the supplier company receives the improved technology without sharing its risk or contributing in recipient's financial burdens. Therefore, these provisions constitute an abusive use of the supplier's dominant position and deprive the technology recipient company of any possibility of improving its competitive position in the global market.

In order to be fair and reasonable, the grant back provision should be on a reciprocal basis during the period of the technology transfer agreement.

Exclusive Sales and Representation Arrangements

Such practices prohibit the freedom of the technology recipient company to organise its own distribution system. Such clauses in the technology transfer agreement prohibit the technology recipient company from entering into exclusive sales or representative contract with any third party, other than the supplier or a party designated by the supplier company. In other words, under these clauses the recipient company becomes handicapped and has to be dependent on the supplier's distribution channels. Therefore, in the presence of such clauses the recipient company cannot supply the product to the parties to whom it wishes to supply.

These clauses as agreed upon under the draft UNCTAD Code have also been recognised as restrictive practices with some exceptions. These exceptions entitle the supplier to require the recipient company to supply product to supplier or the designated party, if the parties to the agreement have agreed to include such clauses in the technology transfer arrangement.

Use of Quality Controls

Quality control and product standards are very important for an entrepreneur. The quality product is of great importance for the supplier company particularly when it involves a trade mark or service mark. The poor quality of product may injure the reputation of supplier attached with its trade mark. With a view to avoid injury to its reputation the supplier company may impose restrictions to manufacture the product of a certain quality. Quality control clauses generally involve in the licensing of trade marks.

Though the quality standards may hinder the possibility of adapting technology to local demands and local resources, yet the inclusion of these clauses can be justified

on the ground that if the product bears a trade mark, the quality standard may be necessary to maintain goodwill with respect to the product. The justification may also be advanced on the ground that a certain quality is essential to ensure the competitiveness of the product on national as well as international market. It has also been supported by the view that the product bearing the same trade mark and having different quality may hamper the supplier's market and give rise to actions on the ground of deceiving the consumers.

Quality requirements and quality controls obliging the technology recipient company to comply with certain quality standards are usually accepted by national legislations, specially where quality controls serve the purpose of avoiding product liability or where trade marks of the licensor are involved. Quality control provisions are, however, prohibited by some countries, if they are used as a means to tieup improperly product sold by the licensor or otherwise ensure the dependence of the licensee.

For long, the Government of India prohibited use of foreign brand names for internal sales. With the announcement of New Industrial Policy of 1991, the prohibition has been removed.

Restrictions on Use of Personnel

The restrictions on the use of personnel are imposed by the supplier company on the basis of non-availability of trained local personnel and high risk or delays which might occur if untrained local staff is used. These clauses may impose a heavy social cost on the community of the host country, specially where the supplier obliges the recipient company to use expert personnel, reserve certain managerial or technical positions for experts or impose discriminatory conditions on the recruitment of local personnel. The use of experts cannot be justified if the local trained personnel are available or can easily be trained. Similarly the appointment of experts on Key positions may be rejected if such appointments are made for a period which is in excess of the time required to train the local personnel. In other circumstances, if local consultant, who might prove more effective, is available for a particular project, the restrictions as to use only foreign consultant cannot be justified.

In this connection it may be argued that the restrictions on use of local personnel may deprive the brain available in the recipient country from rendering their services to the nation and ultimately it may also encourage the problem of brain drain. It may also affect the foreign currency reserves of the recipient country because these personnel or consultants are generally being paid in foreign currency. Consequently, such clauses may restrain the economic development of the developing countries. UNCTAD Code have also prohibited such practices if they are not necessary for the efficient working of the plant.

Restrictions on Publicity

Generally the restrictions on publicity obliges the recipient company to spend a minimum amount or to undertake a certain quantity of advertising. Such practices may relate to the content, channels or amount to be spent on publicity. Restrictions on publicity may be justified where the publicity or advertisement is of the nature which is injurious to the goodwill of the supplier. UNCTAD Code have also

recognised the exemptions to these provisions. It provides that the supplier company may impose such restrictions on the recipient company where the publicity carries the name, trade mark, service mark, trade name or other identifying items. Supplier is also entitled to impose the restrictions on the recipient to avoid the product liability where the supplying party may be subject to such liability and where necessary for safety purposes, to protect the consumers or to secure the confidentiality of the technology transferred.

PROBLEMS ASSOCIATED WITH TECHNOLOGY TRANSFER

The problems associated with technology transfer agreements are numerous. Many Indian companies go in for technology transfer as a short cut method to achieve faster growth, as development of indigenous technology in-house takes longer time. Some of the problems faced by technology recipient companies are:

- Identification of the required level of technology. For this purpose, the recipient may have to depend on the information, product bulletin supplied by the technology supplier company.
- There is no independent agency to advice on the latest technologies and the manner of obtaining such technologies, except through trade exhibitions, personal contacts etc.
- No technology supplier will transfer the technology being used by him. Rather, he may prefer to provide the second level of technology which has already been exploited by him.
- After identification, defining technology transfer in the agreement poses certain practical difficulties. Technology cannot be transferred in one lot through transfer of documents. This may have to be done through transfer of designs and drawings, supply of additions and improvements made by the technology supplier, providing the services of its experts and for training of Indian staff at the works of the technology supplier etc. All these aspects are to be properly and adequately covered in the technology transfer agreement.
- The most difficult task in an imported technology is its indigenisation. While the technology supplier desires the recipient company to achieve the same level of quality to be able to compete in the National and Inter-national markets, the achievement of this goal bristles with practical difficulties.

Product quality depends upon the quality of inputs used and the processes adopted. Quality of raw materials and components available in the technology recipient country not being the same as the host country, adaptation of imported technology and its indigenisation poses a lot of problems. ISO Certification mechanism has been able to address this problem to certain extent, as the emphasis in ISO Certification is process efficiency and this will ensure product efficiency as well.

- The nature of technology transferred for the purposes of manufacture and sale poses another problem.

Exclusive licence to manufacture and sell the product in the technology recipient country provides some measures of protective market for the

products under licence. A non-exclusive licence to sell the product outside the country of manufacture gives the much needed support to make a foray into the international market. What lends greater support to the technology recipient company is the willingness on the part of the technology supplier to source his requirements of parts and components, through a buy-back provision in the technology transfer agreement. This will build up an enduring relationship between the technology supplier and the recipient companies, for mutual benefit and advantage. A buy-back provision can be a commercially successful proposition provided the product manufactured by the technology recipient company is competitive both in terms of quality and price.

- Technological support of an umbrella type is the emerging scenario in these days of inter-nationalisation of business and this provides technology transfer on a continuous basis.
- Long term business relationship can be built up provided that the technology supplier has a stake in the technology recipient company. This is now facilitated by the Government's liberalised policy towards foreign investment through automatic route and by FIPB, as part of new projects.
- Foreign investment is expected to bring in the various advantages of technology transfer, marketing expertise, modern managerial techniques and new possibilities for promotion of exports.

INDIAN JOINT VENTURES ABROAD

The investments in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) abroad have been recognised as important avenues for promoting global business by Indian entrepreneurs in terms of foreign exchange earnings like dividend, royalty, technical know-how fee and other entitlements on such investments. They are also a major source of increased exports of plant and machinery and goods from India. Joint ventures have also been perceived as a medium of economic co-operation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global market, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments.

In keeping with the spirit of liberalisation, which has become the hallmark of economic policy in general, and Exchange Control regulations in particular, Reserve Bank has been progressively relaxing its rules and simplifying the procedures both the current account as well as capital account transactions.

The Foreign Exchange Management Act, 1999 (FEMA) under Section 6 empowers the Reserve Bank to specify, in consultation with the Central Government the classes of permissible Capital Account transactions and limits upto which exchange is admissible for such transactions. Section 6(3) empowers the Reserve Bank to prohibit, restrict or regulate various transactions referred to in the sub-clauses of that sub-section, by making Regulations.

In exercise of the above powers, Reserve Bank has issued Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2000 to

regulate acquisition and transfer of a foreign security by a person resident in India i.e. investment by Indian entities in overseas joint ventures and wholly owned subsidiaries as also investment by a person resident in India in shares and securities issued outside India.

The RBI has granted general permission to residents for purchase/acquisition of securities and sale of shares/securities so acquired –

- (a) out of funds held in RFC account; and
- (b) as bonus shares on existing holding of foreign currency shares.

General permission has also been granted to a person resident in India for purchase of securities out of their foreign currency resources outside India as also for sale of securities so acquired.

DIRECT INVESTMENT OUTSIDE INDIA

Automatic Route

RBI has allowed any Indian party to make investment in overseas Joint Venture (JV)/Wholly Owned Subsidiary (WHO), not exceeding 400 per cent of the net worth of the Indian party as on the date of the last audited balance sheet.

The ceiling of 400 per cent of net worth will not be applicable where the investment is made out of balances held in Exchange Earners' Foreign Currency account of the Indian party or out of funds raised through ADRs/GDRs. The Indian party should approach an Authorised Dealer with an application in Form ODI and prescribe enclosures/documents for effecting remittances towards such investments.

Such overseas investments will include contribution to the capital of the overseas JV/WOS, loan granted to the JV/WOS, and 100 per cent of guarantees issued to or on behalf of the JV/WOS. The investments are subject to the following conditions:

- (a) The Indian entity may extend loan/guarantee to an overseas concern only in which it has equity participation. Indian entities may offer any form of guarantee – corporate or personal/primary or collateral/guarantee by the promoter company/guarantee by group company, sister concern or associate company in India; provided that
 - All financial commitments including all forms of guarantees are within the overall ceiling prescribed for overseas investment by the Indian party i.e. currently within 400 per cent of the net worth of the Indian party,
 - No guarantee is 'open ended' i.e. the amount of the guarantee should be specified upfront, and
 - As in the case of corporate guarantees, all guarantees are required to be reported to Reserve Bank, in Form ODI-Part II. Guarantees issued by banks in India in favour of WOSs/JVs outside India, would be outside this ceiling and would be subject to prudential norms issued by Reserve Bank from time to time.
 - Specific approval of the Reserve Bank will be required for creating charge on immovable property and pledge of shares of the Indian parent/group companies in favour of a non-resident entity.

- (b) The Indian party should not be on the Reserve Bank's Exporters caution list/list of defaulters to the banking system circulated by the Reserve Bank/Credit Information Bureau (India) Ltd. (CIBIL)/or any other Credit information company as approved by the Reserve Bank or under investigation by any investigation/enforcement agency or regulatory body.
- (c) All transactions relating to a JV/WOS should be routed through one branch of an authorised dealer bank to be designated by the Indian party.
- (d) In case of partial/full acquisition of an existing foreign company, where the investment is more than USD 5 million, valuation of the shares of the company shall be made by a Category I Merchant Banker registered with SEBI or an Investment Banker/Merchant Banker outside India registered with the appropriate regulatory authority in the host country; and, in all other cases by a Chartered Accountant or a Certified Public Accountant.
- (e) In cases of investment by way of swap of shares, irrespective of the amount, valuation of the shares will have to be by a Category I Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country. Approval of the Foreign Investment Promotion Board (FIPB) will also be a prerequisite for investment by swap of shares.
- (f) In case of investment in overseas JV/WOS abroad by a registered partnership firm, where entire funding for such investment is done by the firm, it will be in order for individual partners to hold shares for and on behalf of the firm in the overseas JV/WOS if the host country regulations or operational requirements warrant such holdings.
- (g) Investments in JV/WOS abroad by Indian parties through the medium of a Special Purpose Vehicle (SPV) is also permitted under the Automatic Route subject to the conditions that the Indian party is not included in the Reserve Bank's Caution list or is under investigation by the Enforcement Directorate or included in the list of defaulters to the banking system circulated by the Reserve Bank/any other Credit Information company as approved by the Reserve Bank. Indian parties whose names appear in the Defaulters' list require prior approval of the Reserve Bank for the investment.
- (h) An Indian party may acquire shares of a foreign company engaged in a bonafide business activity, in exchange of ADRs/GDRs issued to the latter in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993, and the guidelines issued there under from time to time by the Central Government, provided:
 - (i) ADRs/GDRs are listed on any stock exchange outside India;
 - (ii) The ADR and/or GDR issue for the purpose of acquisition is backed by underlying fresh equity shares issued by the Indian party;
 - (iii) The total holding in the Indian entity by persons resident outside India in the expanded capital base, after the new ADR and/or GDR issue, does not exceed the sectoral cap prescribed under the relevant regulations for such investment under FDI;

- (iv) Valuation of the shares of the foreign company shall be as per the recommendations of the Investment Banker if the shares are not listed on any recognized stock exchange; or based on the current market capitalisation of the foreign company arrived at on the basis of monthly average price on any stock exchange abroad for the three months preceding the month in which the acquisition is committed and over and above, the premium, if any, as recommended by the Investment Banker in its due diligence report in other cases.

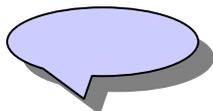
The Indian Party is required to report such acquisition in form ODI to the Authorised Dealer Bank for report to the Reserve Bank within a period of 30 days from the date of the transaction.

Investments in Nepal are permitted only in Indian rupees. Investments in Bhutan are permitted in Indian Rupees as well as in freely convertible currencies. All dues receivable on investments made in freely convertible currencies, as well as their sale/winding up proceeds are required to be repatriated to India in freely convertible currencies only.

The automatic route facility is not available for investment in Pakistan.

Method of Funding

Investment in an overseas JV/WOS may be funded out of one or more of the following sources:



- (i) drawl of foreign exchange from an Authorised Dealer Bank in India;*
- (ii) capitalization of exports;*
- (iii) swap of shares;*
- (iv) utilisation of proceeds of External Commercial Borrowings (ECBs)/Foreign Currency Convertible Bonds (FCCBs);*
- (v) in exchange of ADRs/GDRs issued in accordance with the scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993, and the guidelines issued there under from time to time by the Central Government;*
- (vi) balances held in EEFC account of the Indian party; and*
- (vii) utilisation of proceeds of foreign currency funds raised through ADR/GDR issues.*

In respect of (vi) and (vii) above, the ceiling of 400 per cent of net worth will not apply.

General permission has been granted to residents for purchase/acquisition of securities in the following manner:

- (i) out of funds held in RFC account;
- (ii) as bonus shares on existing holding of foreign currency shares;

- (iii) and when not permanently resident in India, out of their foreign currency resources outside India.

Capitalisation of exports and other dues

- (a) Indian parties are permitted to capitalize the payments due from the foreign entity towards exports, fees, royalties or any other dues from the foreign entity for supply of technical knowhow, consultancy, managerial and other services within the ceilings applicable. Capitalisation of export proceeds remaining unrealized beyond the prescribed period of realization will require prior approval of the Reserve Bank.
- (b) Indian software exporters are permitted to receive 25 per cent of the value of their exports to an overseas software start-up company in the form of shares without entering into Joint Venture Agreements, with prior approval of the Reserve Bank.

Investments in Financial Services Sector

An Indian party seeking to make investment in an entity engaged in the financial sector should fulfill the following additional conditions:

Provided that Indian party:

- (a) is registered with the appropriate regulatory authority in India for conducting the financial sector activities;
- (b) has earned net profit during the preceding three financial years from the financial services activities;
- (c) has obtained approval for investment in financial sector activities abroad from regulatory authorities concerned in India and abroad; and
- (d) has fulfilled the prudential norms relating to capital adequacy as prescribed by the regulatory authority concerned in India.

INVESTMENT IN EQUITY OF COMPANIES REGISTERED OVERSEAS/RATED DEBT INSTRUMENTS**Portfolio Investments by listed Indian companies**

Listed Indian companies are permitted to invest up to 50 per cent of their net worth as on the date of the last audited balance sheet in (i) shares, and (ii) bonds/ fixed income securities, rated not below investment grade by accredited/registered credit rating agencies, issued by listed overseas companies.

Investment by Mutual Funds

Indian Mutual Funds registered with SEBI are permitted to invest within an overall cap USD 7 billion in:

- (a) ADRs/GDRs of the Indian and foreign companies,
- (b) equity of overseas companies listed on recognized stock exchanges overseas,
- (c) initial and follow on public offerings for listing at recognized stock exchanges overseas,
- (d) foreign debt securities in the countries with fully convertible currencies, short term as well as long term instruments with rating not below investment grade by accredited/registered credit agencies,

- (e) money market instruments rated not below investment grade,
- (f) repos in the form of investment, where the counterparty is rated not below investment grade. The repos should not, however, involve any borrowing of funds by mutual funds,
- (g) governmental securities where the countries are related not below investment grade,
- (h) derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities,
- (i) short term deposits with banks overseas where the issuer is related not below investment grade, and
- (j) units/securities issued by overseas Mutual Funds or Unit Trusts registered with overseas regulators and investing in (a) aforesaid securities, (b) Real Estate Investment Trusts (REITs) listed on recognized stock exchanges overseas, or (c) unlisted overseas securities (not exceeding 10 per cent of their net assets).

A limited number of qualified Indian Mutual Funds are permitted to invest cumulatively up to USD 1 billion in overseas Exchange Traded Funds as may be permitted by SEBI.

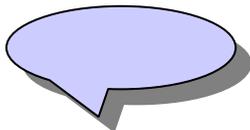
Domestic Venture Capital Funds registered with SEBI may invest in equity and equity linked instruments of off-shore Venture Capital Undertakings, subject to an overall limit of USD 500 million. Accordingly, Mutual Funds/Venture Capital Funds desirous of availing of this facility may approach SEBI for necessary permission.

Overseas Investment by Registered Trust/Society

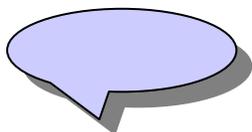
Registered Trusts and Societies engaged in manufacturing/educational sector are allowed make investment in the same sector(s) in a Joint Venture or Wholly Owned Subsidiary outside India, with the prior approval of the Reserve Bank. Trusts/ Societies satisfying the eligibility criteria as given below may submit the application/s in Form ODI-Part I, through their Authorised Dealer.

Eligibility Criteria:

TRUST



- *The Trust should be registered under the Indian Trust Act, 1882;*
- *The Trust deed permits the proposed investment overseas;*
- *The proposed investment should be approved by the trustee/s;*
- *Authorised Dealer Bank is satisfied that the Trust is KYC (Know Your Customer) compliant and is engaged in a bonafide activity;*
- *The Trust has been in existence at least for a period of three years;*
- *The Trust has not come under the adverse notice of any Regulatory/ Enforcement agency like the Directorate of Enforcement, CBI etc.*

SOCIETY

- *The Society should be registered under the Societies Registration Act, 1860.*
- *The Memorandum of Association and rules and regulations permit the Society to make the proposed investment which should also be approved by the governing body/council or a managing/executive committee.*
- *The AD Category-I bank is satisfied that the Society is KYC (Know Your Customer) compliant and is engaged in a bonafide activity;*
- *The Society has been in existence at least for a period of three years;*
- *The Society has not come under the adverse notice of any Regulatory/ Enforcement agency like the Directorate of Enforcement, CBI etc.*

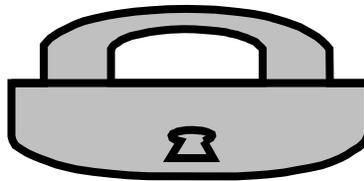
In addition to the registration, the activities which require special license/permission either from the Ministry of Home Affairs, Government of India or from the relevant local authority, as the case may be, the Authorised Dealer Bank should ensure that such special license/permission has been obtained by the applicant, sale of securities so acquired.

LESSON ROUND UP

- Foreign direct investment is freely allowed in all sectors including the services sector, except where the existing and notified sectoral policy does not permit FDI beyond a ceiling. FDI for virtually all items/activities can be brought in through the Automatic Route under powers delegated to the Reserve Bank of India (RBI), and for the remaining items/activities through Government approval. Government approvals are accorded on the recommendation of the Foreign Investment Promotion Board (FIPB).
- With a view to injecting the desired level of technological dynamism in Indian industry and for promoting an industrial environment where the acquisition of technological capability receives priority, foreign technology induction is encouraged both through FDI and through foreign technology collaboration agreements. Foreign technology collaborations are permitted either through the automatic route under delegated powers exercised by the RBI, or by the Government.
- A joint venture is an association of two or more individuals or business entities who combine and pool their respective expertise, financial resources, skills, experience, and knowledge in the furtherance of a particular project or undertaking.

- Joint Ventures are generally created for a single activity or project, and may have a limited time span. Joint Venture agreements, commonly referred to as a “JV”, are typically formed either by individuals, business entities, corporations or partnerships.
- The contributions to the joint ventures are either in the form of money [capital], services, or physical asset(s), i.e. equipment or intellectual property [software, patents], etc., or a combination of all.
- The investments in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) abroad have been recognised as important avenues for promoting global business by Indian entrepreneurs in terms of foreign exchange earnings like dividend, royalty, technical know-how fee and other entitlements on such investments.
- Reserve Bank may on application permit Mutual Funds in India to purchase foreign securities, subject to such terms and conditions as may be stipulated.

SELF TEST QUESTIONS



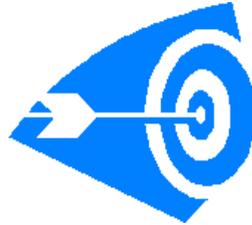
1. Discuss the categories for which the Government's approval through the FIPB route is necessary.
2. What is meant by the term 'Joint Venture'?
3. Discuss the important clauses which should be incorporated in the Foreign Collaboration Agreement.
4. What are the problems faced by the technology recipient companies?
5. What is the ceiling on Foreign Direct Investment outside India through automatic route?

PART C – INTERNATIONAL TRADE

STUDY XI

INTERNATIONAL TRADE AND TREATIES

LEARNING OBJECTIVE



The objective of this study lesson is to enable the students to understand:

- International Trade and Treaties
- Theory of comparative advantages
- Institutionalization of International trade
- Trade Round – The Package Route to Progress
- How is the WTO different from GATT?
- Regional Trading Block
- North American Free Trade Agreement
- SAARC Chamber of Commerce and Industry
- ASEAN

INTRODUCTION

While international trade and commerce is perhaps as old as civilization, the development of international economics as an independent branch of economic theory is a relatively recent phenomenon. From the ancient Greeks to the present, government officials, intellectuals, and economists have pondered the determinants of trade between countries, have analysed whether trade benefits or harms the nations, and, more importantly, have tried to determine what trade policy is best for any particular country.

Since the time of the ancient Greek philosophers, there has been a dual view of trade a recognition of the benefits of international exchange combined with a concern that certain domestic industries (or labourers, or culture) would be harmed by foreign competition. Depending upon the weightage attached to the overall gains from trade or on the losses of those harmed by imports, analysts have arrived at different conclusions about the desirability of having free trade. But economists have linked free trade to technological progress, although some minority interests may be prejudicially affected, the overall benefits to society are substantial. Still, as evidenced by the intense debates over trade today, the tensions inherent in this dual view of trade have never been overcome.

MERCANTILISM

The first reasonably systematic body of thought devoted to international trade is

called "mercantilism" and it emerged in seventeenth and eighteenth century in Europe. An outpouring of pamphlets on economic issues, particularly in England and especially related to trade, began during this time. For a predominant part of this period, mercantilist writers argued that a key objective of trade should be to promote a favourable balance of trade.



A "favourable" balance of trade is one in which the value of domestic goods exported exceeds the value of foreign goods imported. Trade with a given country or region was judged profitable by the extent to which the value of exports exceeded the value of imports, thereby resulting in a balance of trade surplus and adding precious metals and treasure to the country's stock. Scholars later disputed the degree to which mercantilists confused the accumulation of precious metals with increases in national wealth. But without a doubt, mercantilists tended to view exports favorably and imports unfavorably.

Even if the balance of trade was not a specific source of concern, the commodity composition of trade was. Exports of manufactured goods were considered beneficial, and exports of raw materials were considered harmful; imports of raw materials were viewed as advantageous and imports of manufactured goods were viewed as damaging. This ranking of activities was based not only on employment grounds, where processing and adding value to raw materials was thought to generate better employment opportunities than just extraction or primary production of basic goods, but also for building up industries to strengthen the economy and the national defence.

Mercantilists advocated that government policy be directed to arranging the flow of commerce to conform to these beliefs. They sought a highly interventionist agenda, using taxes on trade to manipulate the balance of trade or commodity composition of trade in favor of the home country. But even if the logic of mercantilism was correct, this strategy could never work if all nations tried to follow it simultaneously. This is due to the fact that not every country can have a balance of trade surplus, and not every country can export manufactured goods and import raw materials.

ADAM SMITH'S WEALTH OF NATIONS

While there were anti-mercantilist economic writers during this period, few advocated complete free trade and set out systematic reasons for believing that free trade might be desirable. The breakthrough came with Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776.



With this book, Smith fundamentally changed economic thinking about international trade. Smith argued that economic growth depended upon specialization and the division of labour. Specialization helped promote greater productivity—that is, producing more goods from the same resources, which is essential for achieving higher standards of living. According to Smith, the division of labour was limited by the extent of the market; in other words, small markets would not be able to support a great deal of specialization, whereas larger markets could.

Therefore, it was opined that international trade effectively increased the size of the market for any given country, allowed for more refined specialization, created an international division of labour, and thereby benefited all countries by increasing the world's productivity and output.

Even more than his discussion of the gains from trade, Smith is remembered for his incisive analysis of trade policy, where he details not just the benefits of free trade but the costs of government intervention. Book IV of the *Wealth of Nations* was a sustained and compelling attack on mercantilism. Smith argued that "the great object" of mercantilism was "to diminish as much as possible, the importation of foreign goods for home consumption, and to increase as much as possible the exportation of the produce of domestic industry". These goals were to be achieved through import restrictions, on one hand, and export subsidies on the other. Smith argued against both actions.

Smith quickly dispensed with *export subsidies*, which are payments to domestic firms that enable them to reduce their price to foreign consumers. Smith argued that if a certain trade was unprofitable for private merchants, it was unlikely that it would be profitable for the nation:

"The trades, it is to be observed, which are carried on by means of bounties [subsidies], are the only ones which can be carried on between two nations for any considerable time together, in such a manner as that one of them shall always and regularly lose, or sell its goods for less than it really costs to send them to market. But if the bounty did not repay to the merchant what he would otherwise lose upon the price of his goods, his own interest would soon oblige him to employ his stock in another way, or to find out a trade in which the price of the goods would replace to him, with the ordinary profit, the capital employment in sending them to market. The effect of bounties, like that of all the other expedients of the mercantile system, can only be to force the trade of a country into a channel much less advantageous than that in which it would naturally run of its own accord."

Turning to import restrictions, Smith argued that they would benefit certain domestic industries, but would also diminish competition and give those producers a monopoly in the home market, enabling them to charge higher prices. Monopolies were also prone to mismanagement and were likely to become inefficient. In explaining this, Smith set out his conception of the role of competition:

"Every individual is continually exerting himself to find to the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of society, which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society."

"As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can."

What was the impact of trade regulations?

"No regulation of commerce can increase the quantity of industry in any society

beyond what its capital can maintain. It can only divert a part of it into a direction into which it might not otherwise have gone; and it is by no means certain that this artificial direction is likely to be more advantageous to the society than that into which it would have gone of its own accord."

Indeed, import restrictions were essentially wasteful:

"What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished, no more than that of the above-mentioned artificers; but only left to find out the way in which it can be employed with the greatest advantage. It is certainly not employed to the greatest advantage when it is thus directed towards an object which it can buy cheaper than it can make. The value of its annual produce is certainly more or less diminished when it is thus turned away from producing commodities evidently of more value than the commodity which it is directed to produce. According to the supposition, that commodity could be purchased from foreign countries cheaper than it can be made at home. It could, therefore, have been purchased with a part only of the commodities, or, what is the same thing, with a part only of the price of the commodities, which the industry employed by an equal capital would have produced at home, had it been left to follow its natural course. The industry of the country, therefore, is thus turned away from a more to a less advantageous employment, and the exchangeable value of its annual produce, instead of being increased, according to the intention of the lawgiver, must necessarily be diminished by every such regulation."

Smith made a powerful case that government promotion of trade and government restriction of trade was unwise and harmful. He fundamentally changed the analysis of trade policy and essentially established the presumption that free trade was the best policy unless some other considerations overrode that presumption.

It is interesting to note how some of the WTO principles and agreements still reflect the economic ideas that were first enunciated by Smith.

COMPARATIVE ADVANTAGE

The classical economists writing in the first quarter of the nineteenth century reinforced the case for free trade. The theory of comparative advantage emerged during this period and strengthened the understanding of the nature of trade and its benefits. David Ricardo has received most of the credit for developing this important theory, although James Mill and Robert Torrens had similar ideas around the same time.

The theory of comparative advantage suggests that a country should export goods in the country in which its relative cost advantage, and not the absolute cost advantage, is greatest in comparison to other countries. Suppose that the United States can produce both shirts and automobiles more efficiently than Mexico. But if it can produce shirts twice as efficiently as Mexico and can produce automobiles three

times more efficiently than Mexico, the United States has an *absolute* productive advantage over Mexico in both the goods but a *relative* advantage in producing automobiles. In this case, the United States might export automobiles in exchange for imports of shirts—even though it can produce shirts more efficiently than Mexico. The practical import of the doctrine is that a country may export a good even if a foreign country could produce it more efficiently if that is where its relative advantage lies; similarly, a country may import a good even if it could produce that good more efficiently than the country from which it is importing the good. From Mexico's standpoint, it lacks an absolute productive advantage in either commodity, but has a relative advantage in producing shirts (where its relative disadvantage is least). This trade is beneficial for both the United States and Mexico.

The comparative advantage proposition is incredibly counterintuitive. It states that a less developed country that lacks an absolute advantage in any goods can still engage in mutually beneficial trade, and that an advanced country whose domestic industries are more efficient than those in any other country can still benefit from trade even as some of its industries face intense import competition.

As developed by Adam Smith and the classical economists, the theory of international trade is an enormously powerful one due to its generality. Just like trade between citizens within a nation's borders, international trade was an efficient mechanism for allocating resources and for increasing national welfare, regardless of the level of a country's economic development. Any impediments to trade would detract from the gains from trade and therefore harm the economy. Smith and the classical economists made a powerful case for liberalizing trade from government restrictions (such as import tariffs and quotas) and moving towards free trade.

At the same time, these economists recognized that there may be situations in which a government might wish to sacrifice economic gains for some other political objective. There might be non-economic objectives that are so desirable that they are worth incurring economic losses. For example, Adam Smith argued that the British Navigation Acts, which restricted trade but promoted British shipping, were worthwhile:

"The act of navigation is not favourable to foreign commerce, or to the growth of that opulence which can arise from it... As defence, however, is of much more importance than opulence, the act of navigation is, perhaps, the wisest of all the commercial regulations of England."

THEORETICAL CHALLENGES TO FREE TRADE

Though the benefits of free trade achieved nearly universal assent among the leading economic thinkers by the early nineteenth century, these same economists and those of later generations probed instances of economic gains from deviating from free trade.

(1) One case, proposed by John Stuart Mill in his *Principles of Political Economy* (1848), is that of promoting "infant industries." In that book he stated:

"The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed temporarily (especially in a

young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production, often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience.... A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment. But it is essential that the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it; nor should the domestic producers ever be allowed to expect that it will be continued to them beyond the time necessary for a fair trial of what they are capable of accomplishing."

Although the infant industry argument did not originate with Mill, his recommendation not only gave it intellectual credibility but also generated intense controversy among economists. There was and still is great skepticism about whether trade restrictions provide new industries with the proper incentives to acquire productive knowledge that will reduce their costs. In addition, economists were skeptical about whether governments could correctly identify "infant" industries and distinguish those that stood a chance of growing up from those that were destined to remain infants. Economists were also worried that protection would not be temporary, and would become permanent.

(2) Another case for deviating from free trade, the "terms of trade" argument, deals with the ratio (i.e., the prices) at which countries exchanges exports for imports. The terms of trade are determined by international supply and demand, but these underlying factors could be manipulated by government policy to the benefit of one country. In the 1840s, Robert Torrens—one of the originators of the theory of comparative advantage—argued that reciprocity, not free trade, was the wisest trade policy because a unilateral tariff reduction would lead to a deterioration in the terms of trade. His argument was greeted with great skepticism until John Stuart Mill, in an essay in his book *Essays on Some Unsettled Questions of Political Economy* (1844), developed the theory of reciprocal demand and essentially showed that Torrens was right. Countries that possess the power to affect the prices of goods on the international market may find it advantageous to restrict trade.

For example, the Organization of Petroleum Exporting Countries (OPEC) restricts the exports of oil in order to drive up its price on world markets, thereby improving its terms of trade (the price of its exports relative to its imports) and enriching itself at the expense of other consuming nations. As this example indicates, trade restrictions that improve one country's terms of trade necessarily imply that those terms deteriorate for other countries; the gains of the restricting countries comes at the expense of others. Indeed, the losses of the other countries exceed the gains so, for the world as a whole, free trade is still desirable. But this argument makes it clear that the distribution of the gains from trade across countries could be affected by tariffs.

(3) Other technical challenges have focused on the possible benefits of deviating from free trade when markets do not function perfectly due to externalities, such that

the first-best optimal policies cannot be imposed and trade policies might be a second-best policy, or when there are strategic interactions among firms that generate rents that can be shifted with trade interventions. In most of these cases, however, the case against free trade depends upon special and highly uncertain conditions. In addition, such arguments for government intervention have been countered with three arguments. First, governments generally lack the ability to identify externalities and rents and, even if they could, determining the optimal type and amount of intervention is exceedingly difficult. Second, even if a rationale for intervention existed and the government is capable of imposing the optimal policy, actual policies are not determined in a scientific manner but result from the pressure of self-serving special interests. The interventions would therefore tend to serve private and not public interests, to the detriment of economy. Third, an optimally imposed intervention might endanger retaliation by foreign countries that would erase any gains from that intervention.

For centuries, trade policy has been the subject of intense and spirited debates. Since the beginning of trade between nations, trade has brought general economic benefits but has simultaneously, also harmed specific domestic interest groups. Even during periods of economic growth, one hears complaints from some domestic firms about the damaging effects of foreign competition on their industry. Economic analysis has provided a systematic framework for examining the underlying issues of international trade. Economics provides a way of distinguishing the self-interested claims that trade is harmful to some groups from other arguments that certain trade policies might benefit the nation as a whole. Although economists have consistently stressed the overall gains from international trade, and in recent years have stressed the measurement of those gains, the debate over trade policy is a never-ending one. When it comes to free trade, as Adam Smith once opined, "Not only the prejudices of the public, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it."

INSTITUTIONALISATION OF INTERNATIONAL TRADE

In an effort to give an early boost to trade liberalization after the Second World War and to begin to correct the large overhang of protectionist measures which remained in place from the early 1930s - tariff negotiations were opened among the 23 founding GATT "contracting parties" in 1946. This first round of negotiations resulted in 45,000 tariff concessions affecting \$10 billion - or about one-fifth - of world trade. It was also agreed that the value of these concessions should be protected by early - and largely "provisional" - acceptance of some of the trade rules in the draft ITO Charter. The tariff concessions and rules together became known as the General Agreement on Tariffs and Trade and entered into force in January 1948.

The WTO's predecessor, the GATT, was established on a provisional basis after the Second World War in the wake of other new multilateral institutions dedicated to international economic cooperation - notably the "Bretton Woods" institutions now known as the World Bank and the International Monetary Fund.

The original 23 GATT countries which agreed on a draft Charter for an International Trade Organization (ITO) - a new specialized agency of the United Nations. The Charter was intended to provide not only world trade disciplines but

also contained rules relating to employment, commodity agreements, restrictive business practices, international investment and services.

Although the ITO Charter was finally agreed at a UN Conference on Trade and Employment in Havana in March 1948, its ratification proved impossible in some cases. When the United States government announced, in 1950, that it would not seek Congressional ratification of the Havana Charter, the ITO was effectively dead. Despite its provisional nature, the GATT remained the only multilateral instrument governing international trade from 1948 until the establishment of the WTO.

Although, during the 47 years of implementation, the basic legal text of the GATT remained much as it was in 1948, there were additions in the form of "plurilateral" - voluntary membership agreements and continual efforts to reduce tariffs. Much of this was achieved through a series of "trade rounds".

TRADE ROUNDS – THE PACKAGE ROUTE TO PROGRESS

The biggest leaps forward in international trade liberalization have come through multilateral trade negotiations, or "trade rounds" under the auspices of GATT - the Uruguay Round being the latest and most extensive.

Although often lengthy, trade rounds offer a package approach to trade negotiations; an approach with a number of advantages over issue-by-issue negotiations. For a start, a trade round allows participants to seek and secure advantages across a wide range of issues. Second, concessions which are necessary but would otherwise be difficult to defend in domestic political terms, can be made more easily in the context of a package which also contains politically and economically attractive benefits. Third, developing countries and other less powerful participants have a greater chance of influencing the multilateral system in the context of a round than if bilateral relationships between major trading nations are allowed to dominate. Finally, overall reform in politically sensitive sectors of world trade can be more feasible in the context of a global package - reform of agricultural trade is a good example in the Uruguay Round.

Most of GATT's early trade rounds were devoted to continuing the process of reducing tariffs. The results of the Kennedy Round in the mid-sixties, however, included a new GATT Anti-Dumping Agreement. The Tokyo Round during the seventies was a more sweeping attempt to extend and improve the system.

The Tokyo Round –Reforming the Trading System

Conducted between 1973 and 1979, with 102 participating countries, the Tokyo Round continued GATT's efforts to progressively reduce tariffs. The results included an average one-third cut in customs duties in the world's nine major industrial markets, bringing the average tariff on manufactured products down to 4.7 per cent compared with about 40 per cent at the time of establishment of GATT. The tariff reductions, phased in over a period of eight years, involved an element of harmonization, bringing the highest tariffs down proportionately more than the lowest.

Elsewhere, the Tokyo Round had mixed results. It failed to come to grips with the fundamental problems affecting farm trade and also stopped short of providing a new

agreement on "safeguards" (emergency import measures). Nevertheless, a series of agreements on non-tariff barriers did emerge from the negotiations, in some cases interpreting existing GATT rules, in others breaking entirely new ground. In most cases, only a relatively small number of, mainly industrialized, GATT members ascribed to these agreements and arrangements which, as a consequence, were often referred to as "codes". They include Subsidies and countervailing measures; Technical barriers to trade; Import licensing procedures; Government procurement; Customs valuation; Anti-dumping; Bovine Meat Arrangement; International Dairy Arrangement and Trade in Civil Aircraft.

Several of the above Codes were amended and extended in the Uruguay Round. Those on subsidies and countervailing measures, technical barriers to trade, import licensing, customs valuation and anti-dumping, are now multilateral commitments within the WTO Agreement. In other words, all WTO members are committed to them, while those on government procurement, bovine meat, dairy products and civil aircraft remain "plurilateral" agreements.

DID GATT SUCCEED?

Given its provisional nature and limited field of action, the success of GATT in promoting and securing the liberalization of much of world trade over 47 years is incontestable. Some recent research has however questioned this linkage essentially arguing that non-members of WTO have liberalised faster than WTO members since the WTO members were enjoying GSP benefits and their incentive to liberalise was much more blunted.

Continual reductions in tariffs alone helped spur very high rates of world trade growth – around 8 per cent a year on an average - during the 1950s and 1960s. Also the momentum of trade liberalization helped ensure that trade growth consistently out-paced production growth throughout the GATT era. The rush of new members during the Uruguay Round demonstrated that the multilateral trading system, as then represented by GATT, was recognized as an anchor for development and an instrument of economic and trade reform.

The limited achievement of the Tokyo Round, outside the tariff reduction results, was a sign of difficult times to come. GATT's success in reducing tariffs to such a low level, combined with a series of economic recessions in the 1970s and early 1980s, drove governments to devise other forms of protection for sectors facing increased overseas competition. High rates of unemployment and constant factory closures led governments in Europe and North America to seek bilateral market-sharing arrangements with competitors and to embark on a subsidies race to maintain their hold on agricultural trade. Both these changes undermined the credibility and effectiveness of GATT.

Apart from the deterioration in the trade policy environment, it also became apparent by the early 1980s that the General Agreement was no longer as relevant to the realities of world trade as it had been in the 1940s. For a start, world trade had become far more complex and important than 40 years before. The globalization of the world economy was underway, international investment was exploding and trade in services – not covered by the rules of GATT – was of major interest to more and more countries and, at the same time, closely tied to further increases in world

merchandise trade. In other respects, the GATT had been found wanting: for instance, with respect to agriculture where loopholes in the multilateral system were heavily exploited and efforts at liberalizing agricultural trade met with little success and in the textiles and clothing sector where an exception to the normal disciplines of GATT was negotiated in the form of the Multifibre Arrangement. Even the institutional structure of GATT and its dispute settlement system were giving cause for concern.

Together, these and other factors convinced GATT members that a new effort to reinforce and extend the multilateral system should be attempted – which resulted in the successful conclusion of Uruguay Round.

The Uruguay Round - Creating a New Multilateral Trading System

The seeds of the Uruguay Round were sown in November 1982 at a Ministerial Meeting of GATT members in Geneva. Although Ministers intended to launch a major new trade negotiation, the meeting stalled on the issue of agriculture and was widely regarded as a failure. In fact, the work programme that Ministers agreed formed the basis for what was to become the agenda for Uruguay Round negotiations.

Nevertheless, it took four more years in exploring and clarifying issues and painstaking consensus-building, before Ministers met again in September 1986, in Punta del Este, Uruguay, to agree to launch the Uruguay Round. They were able to accept a negotiating agenda which covered virtually every outstanding trade policy issue including the extension of the trading system into several new areas, notably trade in services and intellectual property. It was the biggest negotiating mandate on trade ever agreed and Ministers gave themselves four years to complete it.

By 1988, the negotiations had reached the stage of a "Mid-term Review". This took the form of a Ministerial Meeting in Montreal, Canada, and led to the elaboration of the negotiating mandate for the second stage of the Round. Ministers agreed to a package of early results which included some concessions on market access for tropical products aimed to assist developing countries as well as a streamlined dispute settlement system and the Trade Policy Review Mechanism which provided for the first comprehensive, systematic and regular reviews of national trade policies and practices of GATT members.

At the Ministerial meeting in Brussels, in December 1990, disagreement on the nature of commitments to future agricultural trade reform led to a decision to extend the round. By December 1991, a comprehensive draft text of the "Final Act", containing legal texts fulfilling every part of the Punta del Este mandate, with the exception of market access results, was on the table in Geneva. For the following two years, the negotiations lurched continuously from impending failure to predictions of imminent success. On 15 April 1994, the deal was finally signed by Ministers of most of the 125 participating governments at a meeting in Marrakesh, Morocco. Presently, the membership of WTO is comprised of 145 countries.

HOW IS THE WTO DIFFERENT FROM GATT?

The World Trade Organization is not a simple extension of GATT, rather it completely replaces its predecessor and has a very different character. The principal differences are given below:

GATT	WTO
The GATT was a set of rules, a multilateral agreement, with no institutional foundation, only a small associated secretariat which had its origins in the attempt to establish an International Trade Organization in the 1940s.	The WTO is a permanent institution with its own secretariat.
The GATT was applied on a "provisional basis" even if, after more than forty seven years, governments chose to treat it as a permanent commitment.	The WTO commitments are full and permanent.
The GATT rules applied to trade in merchandise goods.	In addition to goods, the WTO covers trade in services and trade-related aspects of intellectual property.
While GATT was a multilateral instrument, by the 1980s many new agreements had been added of a plurilateral, and therefore selective in nature.	The agreements which constitute the WTO are almost all multilateral and, thus, involve commitments for the entire membership.
GATT 1947 was an institution as well as an agreement.	WTO has replaced GATT 1947 as an institution, whereas GATT 1994 is GATT 1947 as amended until the Uruguay Round of Negotiations.
The dispute settlement system was not faster, automatic and susceptible to blockages.	The WTO dispute settlement system is faster, more automatic, and thus much less susceptible to blockages, than the old GATT system. The implementation of WTO dispute findings will also be more easily assured.
GATT has contracting Parties, underscoring the fact that officially GATT was a legal text.	The WTO has members.

REGIONAL TRADING BLOCKS

1. ASSOCIATION OF SOUTH-EAST ASIAN NATIONS (ASEAN)

The Association of South-East Asian Nations (ASEAN) was established on 8 August, 1967 in Bangkok by the five original Member Countries, namely, Indonesia,

Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined on 8 January 1984, Vietnam on 28 July 1995, Laos and Myanmar on 23 July 1997, and Cambodia on 30 April 1999.

Objectives

The ASEAN Declaration sets out the aims and purposes of the Association as under:

- (i) to accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South East Asian nations, and
- (ii) to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.

In 1995, the ASEAN Heads of States and Government re-affirmed that the “Cooperative peace and shared prosperity shall be the fundamental goals of ASEAN.”

Fundamental Principles

The Treaty of Amity and Cooperation (TAC) in South-East Asia, signed at the First ASEAN Summit on 24 February 1976, declared that in their relations with one another, the High Contracting Parties should be guided by the following fundamental principles:

- Mutual respect for the independence, sovereignty, equality, territorial integrity, and national identity of all nations;
- The right of every State to lead its national existence free from external interference, subversion or coercion;
- Non-interference in the internal affairs of one another;
- Settlement of differences or disputes by peaceful manner;
- Renunciation of the threat or use of force; and
- Effective cooperation among themselves.

Asian community

The ASEAN Vision 2020, adopted by the ASEAN Leaders on the 30th Anniversary of ASEAN, agreed on a shared vision of ASEAN as a concert of Southeast Asian nations, outward looking, living in peace, stability and prosperity, bonded together in partnership in dynamic development and in a community of caring societies.

At the 9th ASEAN Summit in 2003, the ASEAN Leaders resolved that an ASEAN Community shall be established.

At the 12th ASEAN Summit in January 2007, the Leaders affirmed their strong commitment to accelerate the establishment of an ASEAN Community by 2015 and

signed the Cebu Declaration on the Acceleration of the Establishment of an ASEAN Community by 2015.

The ASEAN Community is comprised of three pillars, namely the ASEAN Political-Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community. Each pillar has its own Blueprint, and, together with the Initiative for ASEAN Integration (IAI) Strategic Framework and IAI Work Plan Phase II (2009-2015), they form the Roadmap for and ASEAN Community 2009-2015.

The ASEAN Charter

The ASEAN Charter serves as a firm foundation in achieving the ASEAN Community by providing legal status and institutional framework for ASEAN. It also codifies ASEAN norms, rules and values; sets clear targets for ASEAN; and presents accountability and compliance.

The ASEAN Charter entered into force on 15 December 2008. A gathering of the ASEAN Foreign Ministers was held at the ASEAN Secretariat in Jakarta to mark this very historic occasion for ASEAN.

With the entry into force of the ASEAN Charter, ASEAN will henceforth operate under a new legal framework and establish a number of new organs to boost its community-building process.

In effect, the ASEAN Charter has become a legally binding agreement among the 10 ASEAN Member States. It will also be registered with the Secretariat of the United Nations, pursuant to Article 102, Paragraph 1 of the Charter of the United Nations.

Structures and Mechanisms

The highest decision-making organ of ASEAN is the Meeting of the ASEAN Heads of State and Government. The ASEAN Summit is convened every year. The ASEAN Ministerial Meeting (Foreign Ministers) is held on an annual basis. Ministerial meetings on several other sectors are also held: agriculture and forestry, economics, energy, environment, finance, information, investment, labour, law, regional haze, rural development and poverty alleviation, science and technology, social welfare, transnational crime, transportation, tourism, youth, the AIA Council and, the AFTA Council. The Secretary-General of ASEAN is appointed on merit and accorded ministerial status. The Secretary-General of ASEAN, who has a five-year term, is mandated to initiate, advise, coordinate, and implement ASEAN activities. The members of the professional staff of the ASEAN Secretariat are appointed on the principle of open recruitment and region-wide competition.

ASEAN has several specialized bodies and arrangements promoting inter-governmental cooperation in various fields namely: ASEAN University Network, ASEAN-EC Management Centre, ASEAN Centre for Energy, ASEAN Agricultural Development Planning Centre, ASEAN Earthquake Information Centre, ASEAN Poultry Research and Training Centre, ASEAN Regional Centre for Biodiversity Conservation, ASEAN Rural Youth Development Centre, ASEAN Specialized Meteorological Centre, ASEAN Tourism Information Centre, and ASEAN Timber

Technology Centre.

In addition, ASEAN promotes cooperative activities with organizations having related aims and purposes such as: ASEAN-Chambers of Commerce and Industry, ASEAN Business Forum, ASEAN Tourism Association, ASEAN Council on Petroleum, ASEAN Ports Association, ASEAN Vegetable Oils Club, and the ASEAN-Institutes for Strategic and International Studies. Furthermore, there are Non-Governmental Organizations (NGOs), which have formal affiliations with ASEAN.

2. EUROPEAN COMMUNITIES/EUROPEAN UNION

The term 'European Communities' is a collective term for the European Coal and Steel Community (ECSC), founded in 1951, the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM or EAEC), founded in 1957. The European Union, created by the Maastricht Treaty, did not make the European Communities disappear. They form its institutional framework. The Union remain based on the Communities, supplemented by the policies and the forms of cooperation - Economic and Monetary Fund, Common Foreign and Security Policy, cooperation in justice and home affairs brought in by that treaty.

The origin of European integration dates back to the end of World War II which had left Europe in ruins and prompted the search for a lasting peace and, in particular, the need to bring about lasting reconciliation between France and Germany. Towards this end, one of the first initiatives was the European Coal and Steel Community (ECSC) established by the Treaty of Paris in 1951. On 9th May 1950 Robert Schuman, the French Foreign Minister, proposed that French and German coal and steel production should be 'pooled'. Belgium, Italy, Luxembourg and the Netherlands joined France and Germany in setting up the ECSC and merging national interests in these industries.

In 1957 the six members of the ECSC formed the European Economic Community (EEC) and began the process of developing a common market for goods and services. The Treaties of Rome, signed in March 1957, created the EEC and the European Atomic Energy Community and a Common Agricultural Policy to support farmers was established. Since 1957, the EEC has seen four stages of enlargement, and now brings together 15 countries in what is known as the European Union (EU). Denmark, Ireland and United Kingdom joined in 1973; Greece in 1981; Portugal and Spain in 1986; and Austria, Finland and Sweden in 1995. The first direct elections to the European Parliament were held in 1979. Before that its members were drawn from national parliaments. Another notable development took place in 1987 with the coming into force of the Single European Act, which set out the timetable for the creation of the Single Market by 1993. This brought about the world's largest trading area of 498 million people and the free movement of goods, capital, people and services. A unique economic and political partnership between 27 democratic European countries. Peace, prosperity and freedom for its 498 million citizens — in a fairer, safer world. Frontier-free travel and trade, the euro (the single European currency), safer food and a greener environment, better living standards in poorer regions, joint action on crime and terror, cheaper phone calls, millions of opportunities to study abroad and much more besides.

The Maastricht Treaty introduced the term “European Union” in November 1993.

The Treaty established new areas of European co-operation in foreign and security policy, and justice and home affairs. The new Treaty also set out a timetable for economic and monetary union and the introduction of a single currency. The Treaty of Amsterdam introduced further changes in 1999. In particular, the powers of the European Parliament were given a major boost and increased cooperation in foreign policy and home affairs was established.

The European Union

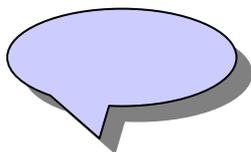
The European Union (EU) has four main institutions namely, the Council of Ministers, the European Commission, the European Parliament and the European Court of Justice. Other bodies such as the Economic and Social Committee and the Committee of the Regions have particular roles to play in the decision making process.

The Council of Ministers

The Council is the EU's main decision-making body. It is the embodiment of the Member States, whose representatives it brings together regularly at ministerial level. The Council is comprised of ministers from national governments of each of the member states. It meets most weeks in Brussels or Luxembourg to deliberate upon legislation and policy. Diplomats and officials in a committee called Coreper, involving the permanent representations to the EU of each member state, prepare the Council's work. The United Kingdom Permanent Representation is known as UKRep.

The Presidency of the Council is held by each member state, in rotation, for a period of six months. The country holding the presidency hosts a meeting of the heads of states and governments every six months, known as the European Council.

The Council has following major responsibilities:



- 1. It is the Union's legislative body; for a wide range of EU issues, it exercises that legislative power in co-decision with the European Parliament;*
- 2. It coordinates the broad economic policies of the Member States;*
- 3. It concludes, on behalf of the EU, international agreements with one or more States or international organisations;*
- 4. It shares budgetary authority with Parliament;*
- 5. It takes the decisions necessary for framing and implementing the common foreign and security policy, on the basis of general guidelines established by the European Council;*
- 6. It coordinates the activities of Member States and adopts measures in the field of judicial cooperation in criminal matters.*

The European Commission

Twenty Commissioners who are charged with furthering the goals of the Union and implementing EU policy and legislation head the EU's administrative and executive body, the Commission. The Commission for consideration and decision by the Council of Ministers and the European Parliament drafts initial proposals for legislation and policy. The Commissioners, who serve for five years, are nominated by national governments and approved by the European Parliament. MEPs have the power to sack the Commission. The headquarters of the Commission is in Brussels.

The Commission is the driving force in the Union's institutional system:

1. It has the right to initiate draft legislation and therefore presents legislative proposals to Parliament and the Council;
2. As the Union's executive body, it is responsible for implementing the European legislation (directives, regulations, decisions), budget and programmes adopted by Parliament and the Council;
3. It acts as guardian of the Treaties and, together with the Court of Justice, ensures that Community law is properly applied;
4. It represents the Union on the international stage and negotiates international agreements, chiefly in the field of trade and cooperation.

The European Parliament

The European Parliament is the democratically elected body whose 626 members (MEPs) are elected every five years. Working in Brussels and Strasbourg, Parliament scrutinises the activities of other EU institutions, passes the annual EU budget, and shapes and decides new legislation jointly with the Council of Ministers. The Parliament has a staff of 3,850.

Elected every five years by direct universal suffrage, the European Parliament is the expression of the democratic will of the Union's 498 million citizens. Brought together within pan-European political groups, the major political parties operating in the Member States are represented.

The Parliament has three essential functions:

1. It shares with the Council the power to legislate, i.e. to adopt European laws (directives, regulations, decisions). Its involvement in the legislative process helps to guarantee the democratic legitimacy of the texts adopted;
2. It shares budgetary authority with the Council, and can therefore influence EU spending. At the end of the procedure, it adopts the budget in its entirety;
3. It exercises democratic supervision over the Commission. It approves the nomination of Commissioners and has the right to censure the Commission. It also exercises political supervision over all the institutions.

The European Court of Justice

Based in Luxembourg, the Court, which has a judge from each member state, adjudicates on all legal issues and disputes involving Community law. The judges, who sit for a period of six years, are assisted by nine advocates-general who give a

preliminary ruling on each case before a final judgement. The Court deals with two main types of actions: those referred to it by national courts for rulings of interpretation of Community law; and those started by one of the other institutions (usually the Commission against a member state).

How European Union work?

EU countries set up bodies to run the EU and adopt its legislation. The main ones are:

- *the European Parliament (representing the people of Europe);*
- *the Council of the European Union (representing national governments);*
- *the European Commission (representing the common EU interest).*



3. NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

In January 1994, Canada, the United States and Mexico launched the North American Free Trade Agreement (NAFTA) and formed the world's largest free trade area. Designed to foster increased trade and investment among the partners, the NAFTA contains an ambitious schedule for tariff elimination and reduction of non-tariff barriers, as well as comprehensive provisions on the conduct of business in the free trade area. These include disciplines on the regulation of investment, services, intellectual property, competition and the temporary entry of businesspersons.

Article 102 of the NAFTA states that: "the objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favoured-nation treatment and transparency, are to:

- eliminate barriers to trade in, and facilitate the cross-border movement of goods and services between the territories of the Parties;
- promote conditions of fair competition in the free trade area;
- increase substantially investment opportunities in the territories of the Parties;
- provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;
- create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and
- establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement."

The NAFTA Secretariat is an independent agency that is responsible for the impartial administration of the dispute settlement provisions of the North American Free Trade Agreement. It has a Canadian, a Mexican, and a United States Section, each headed by a national Secretary, and with offices in each national capital. The Secretariat is accountable to the NAFTA Free Trade Commission, which comprises the ministers responsible for international trade in the three NAFTA partner countries.

4. SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION (SAARC)

The South Asian Association for Regional Cooperation (SAARC) comprises Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. The main goal of the Association is to accelerate the process of economic and social development in member states, through joint action in the agreed areas of cooperation. The idea of regional cooperation in South Asia was first mooted in November 1980. After consultations, the Foreign Secretaries of the seven countries met for the first time in Colombo, in April 1981. This was followed, a few months later, by the meeting of the Committee of the Whole, which identified five broad areas for regional cooperation. The Foreign Ministers, at their first meeting in New Delhi, in August 1983, formally launched the Integrated Programme of Action (IPA) through the adoption of the Declaration on South Asian Regional Cooperation (SARC). At the First Summit held in Dhaka on 7-8 December 1985, the Charter establishing the South Asian Association for Regional Cooperation (SAARC) was adopted.

Objectives

The objectives, principles and general provisions, as mentioned in the SAARC Charter, are as follows:

- To promote the welfare of the peoples of South Asia and to improve their quality of life;
- To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potentials;
- To promote and strengthen collective self-reliance among the countries of South Asia;
- To contribute to mutual trust, understanding and appreciation of one another's problems;
- To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
- To strengthen cooperation with other developing countries;
- To strengthen cooperation among themselves in international forums on matters of common interests; and
- To cooperate with international and regional organizations with similar aims and purposes.

Principles

- Cooperation within the framework of the Association is based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other states and mutual benefit.
- Such cooperation is to complement and not to substitute bilateral or multilateral cooperation.
- Such cooperation should be consistent with bilateral and multilateral obligations of the member states.

- Decisions at all levels in SAARC are taken on the basis of unanimity.
- Bilateral and contentious issues are excluded from its deliberations.

Institutional structure

Summits

The highest authority of the Association rests with the Heads of State or Government.

Council of Ministers

Comprising of the Foreign Ministers of member states it is responsible for the formulation of policies; reviewing progress; deciding on new areas of cooperation; establishing additional mechanisms as deemed necessary; and deciding on other matters of general interest to the Association. The Council meets twice a year and may also meet in extraordinary session by agreement of member states.

Standing Committee

Comprising of the Foreign Secretaries of member states it is entrusted with the overall monitoring and coordination of programmes and the modalities of financing; determining inter-sectoral priorities; mobilising regional and external resources; and identifying new areas of cooperation based on appropriate studies. It may meet as often as deemed necessary but in practice it meets twice a year and submits its reports to the Council of Ministers.

Programming Committee

Comprising of the senior officials it meets prior to the Standing Committee sessions to scrutinize Secretariat Budget, finalise the Calendar of Activities and take up any other matter assigned to it by the Standing Committee.

Technical Committees

Comprising of representatives of member states, they formulate programmes and prepare projects in their respective fields. They are responsible for monitoring the implementation of such activities and report to the Standing Committee. The Chairmanship of each Technical Committee normally rotates among member countries in alphabetical order, every two years.

Action Committees

According to the SAARC Charter, there is a provision for Action Committees comprising member states concerned with implementation of projects involving more than two, but not all member states.

SAARC Secretariat

Established in Kathmandu on 16 January 1987, the SAARC Secretariat is responsible for coordinating and monitoring the implementation of SAARC activities,

servicing the meetings of the Association and serving as the channel of communication between SAARC and other international organizations. The Secretariat comprises of the Secretary-General, a Director from each member state and the General Services Staff.

SOUTH ASIAN PREFERENTIAL TRADING AREA

At the Colombo Summit in December 1991, the Heads of State or Government approved the establishment of an Intergovernmental Group (IGG) to seek agreement on an institutional framework under which specific measures for trade liberalization among SAARC member states could be furthered. IGG evolved a draft Agreement on SAARC Preferential Trading Arrangement (SAPTA) during its first two Meetings. Subsequently, the Council of Ministers, upon the recommendation of CEC signed the framework Agreement on SAPTA in Dhaka on 11 April 1993 during the Seventh SAARC Summit.

The basic principles underlying SAPTA are:

- overall reciprocity and mutuality of advantages so as to benefit equitably all Contracting States, taking into account their respective level of economic and industrial development, the pattern of their external trade, and trade and tariff policies and systems;
- negotiation of tariff reform step by step, improved and extended in successive stages through periodic reviews;
- recognition of the special needs of the Least Developed Contracting States and agreement on concrete preferential measures in their favour; and
- inclusion of all products, manufactures and commodities in their raw, semi-processed and processed forms.

Four rounds of trade negotiations have been concluded under SAPTA covering over 5000 commodities. Each Round contributed to an incremental trend in the product coverage and the deepening of tariff concessions over previous Round

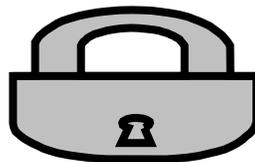
SOUTH ASIAN FREE TRADE AREA (SAFTA)

SAPTA was envisaged primarily as the first step towards the transition to a South Asian Free Trade Area (SAFTA) leading subsequently towards a Customs Union, Common Market and Economic Union. In 1995, the Sixteenth session of the Council of Ministers (New Delhi, 18-19 December 1995) agreed on the need to strive for the realization of SAFTA and to this end an Inter-Governmental Expert Group (IGEG) was set up in 1996 to identify the necessary steps for progressing to a free trade area. The Tenth SAARC Summit (Colombo, 29-31 July 1998) decided to set up a Committee of Experts (COE) to draft a comprehensive treaty framework for creating a free trade area within the region, taking into consideration the asymmetries in development within the region and bearing in mind the need to fix realistic and achievable targets.

The Agreement on South Asian Free Trade Area (SAFTA) was signed on 6 January 2004 during the Twelfth SAARC Summit in Islamabad. The Agreement entered into force on 1 January 2006.

LESSON ROUND UP

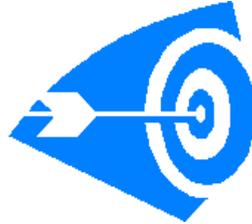
- International trade and commerce is perhaps as old as civilization, the development of international economics as an independent branch of economic theory is a relatively recent phenomenon.
- The first reasonably systematic body of thought devoted to international trade is called "mercantilism" and emerged in seventeenth and eighteenth century in Europe.
- The objective of ASEAN is to accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South East Asian nations, and to promote regional peace and stability through abiding respect for Justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.
- The European Union (EU) has four main institutions namely, the Council of Ministers, the European Commission, the European Parliament and the European Court of Justice. Other bodies such as the Economic and Social Committee and the Committee of the Regions have particular roles to play in the decision making process.
- The South Asian Association for Regional Cooperation (SAARC) comprises Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. The main goal of the Association is to accelerate the process of economic and social development in member states, through joint action in the agreed areas of cooperation.

SELF TEST QUESTIONS

1. Explain the objectives and principles of ASEAN.
2. What make WTO different from GATT?
3. Write short notes on:
 - (i) Mercantilism;
 - (ii) SAARC.
4. How did European Union emerge from European communities?
5. Why was SAFTA created and what objectives has it achieved?

STUDY XII
**INTERNATIONAL TRADE AND TREATIES
(WORLD TRADE ORGANISATION)**

LEARNING OBJECTIVE



The objective of this study lesson is to enable the students to understand:

- Structure of World Trade Organisation
- Most- Favoured-Nation
- National Treatment
- Basic principle of GATS
- Intellectual Property Right
- World Intellectual Property Organisation
- Anti-Dumping and Countervailing Duties
- Rules of Origin
- Plurilateral agreements
- Trade policy review
- Disputes Settlement Body

INTRODUCTION

The economic case for an open trading system based upon multilaterally agreed rules is simple enough and rests largely on commercial common sense. But it is also supported by evidence, the experience of world trade and economic growth since the Second World War. Tariffs on industrial products have fallen steeply and are now close to 4% on average in industrial countries by 1 January 1999. During the first decades after the war, world economic growth averaged about 5% per year, a high rate that was partly the result of lower trade barriers. World trade grew even faster, averaging about 8% during the period. The data show a definite statistical link between free trade and economic growth.

Economic theory points to strong reasons for the link. All countries, including the poorest, have assets, human, industrial, natural, financial, viz., which they can employ to produce goods and services for their domestic markets or to compete overseas. Economics tells us that we can benefit when these goods and services are traded. Simply put, the principle of “comparative advantage” says that countries prosper first by taking advantage of their assets in order to concentrate on what they can produce best, and then by trading these products for products that other

countries produce best. Firms do exactly that quite naturally on the domestic market. But what about the international market? Most firms recognize that the bigger the market the greater their potential.

- They can expand until they are at their most efficient size, and they can have access to large numbers of customers.
- Policies that allow the unrestricted flow of goods and services — multiply the rewards that result from producing the best products, with the best design, at the best price. But success in trade is not static. The ability to compete well in particular products can shift from company to company when the market changes or new technologies make cheaper and better products possible.

However, with the stimulus of an open economy, the country can move on to become competitive in some other goods or services. This is normally a gradual process. When the trading system is allowed to operate without the constraints of protectionism, firms are encouraged to adapt gradually and in a relatively painless way. They can focus on new products, find a new “niche” in their current area or expand into new areas. The alternative is protection against competition from imports, and perpetual government subsidies. That leads to bloated, inefficient companies supplying consumers with outdated, unattractive products. Ultimately, factories close and jobs are lost despite the protection and subsidies. If other governments around the world pursue the same policies, markets contract and world economic activity is reduced.

One of the objectives of the WTO is to prevent such a self-defeating and destructive drift into protectionism. Nobel laureate Paul Samuelson was once challenged by the mathematician Stanislaw Ulam to “name one proposition in all of the social sciences which is both true and non-trivial.” It took Samuelson several years to find the answer — comparative advantage. “That it is logically true need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them.”

ROOTS FROM HAVANA TO MARRAKESH

The WTO's creation on 1 January 1995 marked the biggest reform of international trade since the Second World War. It also brought to reality — in an updated form — the failed attempt to create an international Trade Organization (ITO) in 1948. Up to 1994, the trading system came under GATT, salvaged from the aborted attempt to create the ITO. GATT helped establish a strong and prosperous multilateral trading system that became more and more liberal through rounds of trade negotiations. But by the 1980s the system needed a thorough overhaul. This led to the Uruguay Round, and ultimately to the WTO.

The General Agreement on Tariffs and Trade (GATT) (a provisional agreement for almost half a century from 1948-1994) provided the rules for much of world trade and presided over periods that saw some of the highest growth rates in international commerce. It seemed well established, but throughout those 47 years, it was a provisional agreement and organization.

The original intention was to create a third institution handling international economic cooperation, to join the “Bretton Woods” institutions now known as the World Bank and the International Monetary Fund. The complete plan, as envisaged originally was to create an International Trade Organization (ITO) as a specialized agency of the United Nations. The draft ITO Charter was ambitious. It extended beyond world trade disciplines, to include rules on employment, commodity agreements, restrictive business practices, international investment, and services. Even before the charter was finally approved, 23 of the 50 participants decided in 1946 to negotiate to reduce and bind customs tariffs. With the Second World War only recently ended, they wanted to give an early boost to trade liberalization, and to begin to correct the large legacy of protectionist measures, which remained in place from the early 1930s.

The 23 participants also agreed that they should accept some of the trade rules of the draft ITO Charter. This, they believed, should be done swiftly and “provisionally” in order to protect the value of the tariff concessions they had negotiated. The combined package of trade rules and tariff concessions became known as the General Agreement on Tariffs and Trade. It entered into force in January 1948, while the ITO Charter was still being negotiated. The 23 participants became GATT founding members (officially, “contracting parties”).

For almost half a century, the GATT’s basic legal text remained much as it was in 1948. There were additions in the form of “plurilateral” agreements (i.e. with voluntary membership), and efforts to reduce tariffs further continued. Much of this was achieved through a series of multilateral negotiations known as “trade rounds” — the biggest leaps forward in international trade liberalization have come through these rounds, which were held under GATT’s auspices. In the early years, the GATT trade rounds concentrated on further reducing tariffs. Then, the Kennedy Round in the mid-sixties brought about a GATT Anti-Dumping Agreement. The Tokyo Round during the seventies was the first major attempt to tackle trade barriers that do not take the form of tariffs, and to improve the system. The eighth, the Uruguay Round of 1986-94, was the latest and most extensive of all. It led to the WTO and a new set of agreements.

THE URUGUAY ROUND

It took seven and a half years, almost twice the original schedule. By the end, 123 countries were taking part. It covered almost all trade, from toothbrushes to pleasure boats, from banking to telecommunications, from the genes of wild rice to AIDS treatments. It was quite simply the largest trade negotiation ever, and most probably the largest negotiation of any kind in international trade history. At times it seemed doomed to fail. But in the end, the Uruguay Round brought about the biggest reform of the world’s trading system since GATT was created at the end of the Second World War. And yet, despite its troubled progress, the Uruguay Round did see some early results. Within only two years, participants had agreed on a package of cuts in import duties on tropical products — which are mainly exported by developing countries. They had also revised the rules for settling disputes, with some measures implemented on the spot. And they called for regular reports on GATT members’ trade policies, a move considered important for making trade regimes transparent around the world. A round to end all rounds?

The seeds of the Uruguay Round were sown in November 1982 at a ministerial meeting of GATT members in Geneva. Although the ministers intended to launch a major new negotiation, the conference stalled on the issue of agriculture and was widely regarded as a failure. In fact, the work programme that the ministers agreed formed the basis for what was to become the Uruguay Round negotiating agenda. Nevertheless, it took four more years of exploring, clarifying issues and painstaking consensus-building, before ministers agreed to launch the new round. They did so in September 1986, in Punta del Este, Uruguay. They eventually accepted a negotiating agenda, which covered virtually every outstanding trade policy issue. The talks were going to extend the trading system into several new areas, notably trade in services and intellectual property, and to reform trade in the sensitive sectors of agriculture and textiles.

All the original GATT articles were up for review. It was the biggest negotiating mandate on trade ever agreed, and the ministers gave themselves four years to complete it. Two years later, in December 1988, ministers met again in Montreal, Canada for what was supposed to be an assessment of progress at the round's halfway point. The purpose was to clarify the agenda for the remaining two years, but the talks ended in a deadlock that was not resolved until officials met more quietly in Geneva. Despite the difficulty, during the Montreal meeting, ministers did agree a package of early results. These included some concessions on market access for tropical products — aimed at assisting developing countries — as well as a streamlined dispute settlement system, and the Trade Policy Review mechanism which provided for the first comprehensive, systematic and regular reviews of national trade policies and practices of GATT members. The round was supposed to end when ministers met once more in Brussels, in December 1990. But they disagreed on how to reform agricultural trade and decided to extend the talks. The Uruguay Round entered its bleakest period. Despite the poor political outlook, a considerable amount of technical work continued, leading to the first draft of a final legal agreement. The then GATT director general, Mr. Arthur Dunkel, who chaired the negotiations at officials' level, compiled this draft "Final Act".

The 15 original Uruguay Round subjects namely, Tariffs, Non-tariff barriers, Natural resource products, Textiles and clothing, Agriculture Tropical products, GATT articles, Tokyo Round codes, Anti-dumping, Subsidies, Intellectual property, Investment measures, Dispute settlement, The GATT system, Services were put on the table in Geneva in December 1991.

The text fulfilled every part of the Punta del Este mandate, with one exception — it did not contain the participating countries' lists of commitments for cutting import duties and opening their services markets. The draft became the basis for the final agreement. For the following two years, the negotiations lurched between impending failures, to predictions of imminent success. Several deadlines came and went. New points of major conflict emerged to join agriculture: services, market access, anti-dumping rules, and the proposed creation of a new institution. Differences between the United States and European Communities (EU) became central to hopes for a final, successful conclusion. In November 1992, the EU and US settled most of their differences on agriculture in a deal known informally as the "Blair House accord". By July 1993 the "Quad" (US, EU, Japan and Canada) announced significant progress in negotiations on tariffs and related subjects.

On 15 April 1994, the deal was signed by ministers from most of the 123 participating governments at a meeting in Marrakesh, Morocco. The delay had some merits. It allowed some negotiations to progress further than would have been possible in 1990: for example — some aspects of services and intellectual property, and the creation of the WTO itself.

DOHA MINISTERIAL CONFERENCE

In a dramatic reversal of the Seattle Ministerial Conference, the WTO member countries went ahead to launch a new round of trade negotiations at the 4th MC at Doha.

The WTO Doha ministerial conference produced three key documents:

- (i) Declaration on TRIPS Agreement and Public Health – This declaration represents some weakening of the TRIPS agreement in so far as access to medicines is concerned. Article 39 of the TRIPS Agreement allows member countries to authorize third parties to produce a patented product through ‘compulsory licences’ to satisfy local needs. This authorization must however be preceded by efforts by the third party to obtain authorization from the patent holder on reasonable commercial terms. This requirement can be waived only in ‘national emergency or other circumstances of extreme urgency’.

The Doha declaration on TRIPS weakens the condition under which the member states can issue compulsory licenses. Each member has a right to grant compulsory licenses and the freedom to determine the grounds upon which such licenses are issued. Each member also has been given the right to determine what constitute national emergency or other extreme urgency, it being understood that HIC/AIDS, malaria, and other epidemics or national health crisis could constitute national emergency. But countries that do not have domestic capability for such production will effectively be unable to benefit from this flexibility.

- (ii) Decision on Implementation-related issues and concerns – Developing countries have had a series of complaints about the manner in which the various WTO agreements have been implemented in practice. The problem with these issues is that virtually no issue involved herein warrants sufficient ground for invoking the DSB investigations. All of them involve either implementation of non-binding, best endeavour clauses in the UR agreement or new concessions. But the Doha Decision on these issues and concerns have landed on future negotiating agenda of the Doha Ministerial Declaration with developed countries mainly offering ‘best endeavour’, ‘good faith effort’ clauses in the Decision.
- (iii) Doha Ministerial Declaration – The Doha Work Programme, launched by Doha MD can be divided into three parts:
 - Agenda with clear negotiating mandate: For seven items: implementation, agriculture, services, market access for non-agriculture products, trade and environment, WTO rules, TRIPS and Dispute Settlement. The first six of these constitute a single undertaking with 1 January, 2005 as deadline for their completion. Last

item can be wrapped up separately by 31 May, 2003.

- Singapore Issues – with ambiguous negotiating mandate. These are MAI, competition policy, trade facilitation, and transparency in government procurement.
- Study programme: On trade and investment, trade and competition policy, trade and environment, intellectual property, e-commerce, small economies, trade, debt and finance etc.

WORLD TRADE ORGANIZATION

The World Trade Organization (WTO) is the only international body dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground-rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. Although negotiated and signed by governments, the goal is to help producers of goods and services, exporters, and importers conduct their business. The system's overriding purpose is to help trade flow as freely as possible — so long as there are no undesirable side effects. That partly means removing obstacles. It also means ensuring that individuals, companies and governments know what the trade rules are around the world, and giving them the confidence that there will be no sudden changes of policy. In other words, the rules have to be "transparent" and predictable. Because the agreements are drafted and signed by the community of trading nations, often after considerable debate, one of the WTO's most important functions is to serve as a forum for trade negotiations. Another important aspect of the WTO is dispute settlement. Trade relations often involve conflicting interests. Contracts and agreements, including those painstakingly negotiated in the WTO system, often need interpreting. The most harmonious way to settle these differences is through some neutral procedure based on an agreed legal foundation. That is the purpose behind the dispute settlement process provided under the WTO agreements.

The WTO began life on 1 January 1995, but its trading system is half a century older. Since 1948, the General Agreement on Tariffs and Trade (GATT) had provided the rules for the system. The second ministerial meeting, held in Geneva in May 1998, included a celebration of the 50th anniversary of the system. It did not take long for the General Agreement to give birth to an unofficial, *de facto* international organization, also known informally as GATT. Over the years GATT evolved through several rounds of negotiations. The latest and largest round, was the Uruguay Round which lasted from 1986 to 1994 and led to the establishment of WTO. Whereas GATT had mainly dealt with trade in goods, the WTO and its agreements now cover trade in services, and in traded inventions, creations and designs (intellectual property). 'Multilateral' trading system is the system operated by the WTO and nations are members of the system.

Highest authority: the Ministerial Conference

WTO belongs to its members. The countries make their decisions through various councils and committees, whose membership consists of all WTO members. Topmost is the ministerial conference which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the

multilateral trade agreements. The WTO is run by its member governments. Decisions are normally taken by consensus.

WTO rules impose disciplines on countries' policies that are the outcome of negotiations among WTO members. The rules are enforced by the members themselves under agreed procedures that they negotiated, including the possibility of trade sanctions. But those sanctions are imposed by member countries, and authorized by the membership as a whole.

Second level: General Council

Day-to-day work in between the ministerial conferences is handled by three bodies:

- The General Council
- The Dispute Settlement Body
- The Trade Policy Review Body

All three are in fact the same — the Agreement Establishing the WTO states they are all the General Council, although they meet under different terms of reference. Again, all three consist of all WTO members. They report to the Ministerial Conference.

The General Council acts on behalf of the Ministerial Conference on all WTO affairs. It meets as the Dispute Settlement Body and the Trade Policy Review Body to oversee procedures for settling disputes between members and to analyse members' trade policies.

Third level: Councils for each broad area of trade, and more

Three more councils, each handling a different broad area of trade, report to the General Council:

- The Council for Trade in Goods (Goods Council)
- The Council for Trade in Services (Services Council)
- The Council for Trade-Related Aspects of Intellectual Property Rights (TRIPS Council)

As their names indicate, the three are responsible for the workings of the WTO agreements dealing with their respective areas of trade. Again they consist of all WTO members. The three also have subsidiary bodies.

Six other bodies report to the General Council. The scope of their coverage is smaller, so they are "committees". But they still consist of all WTO members. They cover issues such as trade and development, the environment, regional trading arrangements, and administrative issues. The Singapore Ministerial Conference in December 1996 decided to create new working groups to look at investment and competition policy, transparency in government procurement, and trade facilitation.

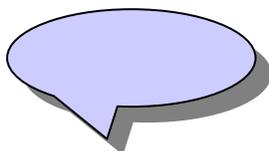
Two more subsidiary bodies dealing with the plurilateral agreements (which are not signed by all WTO members) keep the General Council informed of their activities regularly.

Fourth level: down to the nitty-gritty

Each of the higher level councils has subsidiary bodies. The Goods Council has 11 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures and so on). Again, these consist of all member countries. Also reporting to the Goods Council is the Textiles Monitoring Body, which consists of a chairman and 10 members acting in their personal capacities, and groups dealing with notifications (governments informing the WTO about current and new policies or measures) and state trading enterprises.

The Services Council's subsidiary bodies deal with financial services, domestic regulations, GATS rules and specific commitments.

At the General Council level, the Dispute Settlement Body also has two subsidiaries: the dispute settlement "panels" of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals.

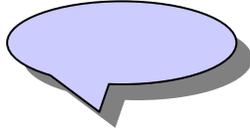
Functions of WTO are as under:

- *To analysis world trade*
- *Administering trade agreements*
- *Acting as a forum for trade negotiations*
- *Settling trade disputes*
- *Reviewing national trade policy*
- *Assisting developing countries in trade policy issues, through technical assistance and training programmes.*
- *Cooperating with other international organization.*
- *To explain WTO affairs to general public.*
- *Advising Government wishing to become member of WTO.*

PRINCIPLES OF THE TRADING SYSTEM

The WTO agreements are lengthy and complex because they are legal texts covering a wide range of activities. They deal with — agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards, food sanitation regulations, intellectual property, and much more. But a number of simple, fundamental principles run throughout all of these documents. These principles are the foundation of the multilateral trading system.

The principles in respect of trading system should be



- *Without discrimination — a country should not discriminate between its trading partners (they are all, equally, granted “most-favoured-nation” or MFN status); and it should not discriminate between its own and foreign products, services or nationals (they are given “national treatment”);*
- *Freer — with barriers coming down through negotiation;*
- *Predictable — foreign companies, investors and governments should be confident that trade barriers (including tariffs, non-tariff barriers and other measures) should not be raised arbitrarily; more and more tariff rates and market-opening commitments are “bound” in the WTO;*
- *More competitive — by discouraging “unfair” practices such as export subsidies and dumping products at below cost to gain market share;*
- *More beneficial for less developed countries — by giving them more time to adjust, greater flexibility, and special privileges.*

TRADE WITHOUT DISCRIMINATION

Most-favoured-nation (MFN)

Why is it called 'most-favoured'? It suggests some kind of special treatment for one particular country, but in the WTO it actually means non-discrimination — treating virtually everyone equally. What happens under the WTO is this, each member treats all the other members equally as “most-favoured” trading partners. If a country improves the benefits that it gives to one trading partner, it has to give the same “best” treatment to all the other WTO members so that they all remain “most-favoured”. Most-favoured nation (MFN) status did not always mean equal treatment. In the 19th Century, when a number of early bilateral MFN treaties were signed, being included among a country’s “most-favoured” trading partners was like being in an exclusive club because only a few countries enjoyed the privilege. Now, when most countries are in the WTO, the MFN club is no longer exclusive. The MFN principle ensures that each country treats its over-153 fellow-members equally.

But there are some exceptions...

Treating other people equally under the WTO Agreements, countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members. This principle is known as most-favoured nation (MFN) treatment. It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in

the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO. Some exceptions are allowed. For example, countries within a region can set up a free trade agreement that does not apply to goods from outside the group or a country can raise barriers against products from specific countries that are considered to be traded unfairly. And in services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services for all its trading partners.

National treatment

Treating foreigners and locals equally. Imported and locally produced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of “national treatment” (giving others the same treatment as one’s own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these. National treatment only applies once a product; service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally produced products are not charged an equivalent tax.

Free Trade

Gradually, through negotiation Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. Since GATT’s creation in 1947-48 there have been eight rounds of trade negotiations. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the late 1980s industrial countries’ tariff rates on industrial goods had fallen steadily to about 6.3%, and subsequently the negotiations had expanded to cover non-tariff barriers on goods, and to the new areas such as services and intellectual property. Opening markets can be beneficial, but it also requires adjustment. The WTO agreements allow countries to introduce changes gradually, through “progressive liberalization”. Developing countries are usually given longer time to fulfil their obligations.

Predictability

Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable. In the WTO, when countries agree to open their markets for goods or services, they “bind” their commitments. For goods, these bindings amount to ceilings on customs tariff rates.

One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In agriculture, 100% of products now have bound tariffs. The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports.

Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

The WTO is sometimes described as a “free trade” institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair and undistorted competition. The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade. Many of the other WTO agreements aim to support fair competition such as agreement on agriculture, intellectual property, services, for example. The agreement on government procurement extends competition rules to purchases by thousands of “government” entities in many countries and so on.

Encouraging development and economic reform, it is widely recognized by economists and trade experts that the WTO system contributes to development. It is also recognized that the least developed countries need flexibility in the time they take to implement the agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries. Over three quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programmes autonomously. At the same time, developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round.

WTO AND GATT

Are they the same? No. They are different — the WTO is GATT plus a lot more. It is probably best to be clear from the start that the General Agreement on Tariffs and Trade (GATT) contained: (1) an international agreement, i.e. a document setting out the rules for conducting international trade, and (2) an international organization created later to support the agreement. The text of the agreement could be compared to law, the organization was like parliament and the courts combined in a single body. GATT, the international agency, no longer exists. The World Trade Organization has now replaced it. GATT, the agreement, does still exist, but it is no longer the main set of rules for international trade. And it has been updated. What happened? When GATT was created after the Second World War, trade in goods dominated international commerce. Since then, trade in services — transport, travel, banking, insurance, telecommunications, transport, consultancy and so on — has

become much more important. So has trade in ideas — inventions and designs, and goods and services incorporating this “intellectual property”. The General Agreement on Tariffs and Trade always dealt with trade in goods, and it still does. It has been amended and incorporated into the new WTO agreements. The updated GATT lives alongside the new General Agreement on Trade in Services (GATS) and Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The WTO brings the three together within a single organization, a single set of rules and a single system for resolving disputes. In short, the WTO is not a simple extension of GATT. It is much more in existence. While GATT no longer exists as an international organization, the GATT agreement lives on. The old text is now called “GATT 1947”. The updated version is called “GATT 1994”. As the more mature WTO developed out of GATT, one could say that the child is the father of the man.

WTO AGREEMENTS — AN OVERVIEW

The WTO Agreements cover goods, services and intellectual property. They spell out the principles of liberalization, and the permitted exceptions. They include individual countries’ commitments to lower customs tariffs and other trade barriers, and to open and keep open services markets. They set procedures for settling disputes. They prescribe special treatment for developing countries. They require governments to make their trade policies transparent by notifying the WTO about laws in force and measures adopted, and through regular reports by the secretariat on countries’ trade policies.

The table of contents of “The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts” is a daunting list of about 60 agreements, annexes, decisions and understandings. In fact, the agreements fall into a simple structure. The agreements for the two largest areas of trade — goods and services — share a common three-part outline, even though the detail is sometimes quite different.

They start with broad principles. The General Agreement on Tariffs and Trade (GATT) (for goods), and the General Agreement on Trade in Services (GATS). The agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) also falls into this category although at present it has no additional parts. Then come extra agreements and annexes dealing with the special requirements of specific sectors or issues. Finally, there are the detailed and lengthy schedules (or lists) of commitments made by individual countries allowing specific foreign products or service-providers access to their markets. For GATT, these take the form of binding commitments on tariffs for goods in general, and combinations of tariffs and quotas for some agricultural goods. For GATS, the commitments state how much access foreign service providers are allowed for specific sectors, and they include lists of types of services where individual countries say they are not applying the “most-favoured-nation” principle of non-discrimination. Much of the Uruguay Round dealt with the first two parts: general principles and principles for specific sectors. At the same time, market access negotiations were possible for industrial goods. Once the principles had been worked out, negotiations could proceed on the commitments.

The Agreements

For goods (under GATT)

— Agriculture

- Health regulations for farm products
- Textiles and clothing
- Product standards (TBT)
- Investment measures
- Anti-dumping measures
- Customs valuation methods
- Pre shipment inspection
- Rules of origin
- Import licensing
- Subsidies and counter-measures
- Safeguards

For services (the GATS annexes)

- Movement of natural persons
- Air transport
- Financial services
- Shipping
- Telecommunications for sectors such as agriculture and services. Negotiations after the Uruguay Round have focused largely on market access commitments: financial services, basic telecommunications, and maritime transportation (under GATS), and information technology (under GATT).

Additional agreements

Two other groups of agreements not included are also important: the agreement on trade policy reviews, and the two “plurilateral” agreements not signed by all members: civil aircraft and government procurement.

Tariffs: More bindings

The bulkiest result of Uruguay Round is the individual countries’ commitments on specific categories of goods and services. These include commitments to cut and “bind” their customs duty rates on imports of goods. In some cases, tariffs are being cut to zero — with zero rates also committed in 1997 on information technology products. There is also a significant increase in the number of “bound” tariffs — duty rates that are committed in the WTO and are difficult to raise.

At the end of the Uruguay Round, individual countries listed their commitments in schedules annexed to Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994. This is the legally binding agreement for the reduced tariff rates. Numerical targets for cutting subsidies and protection. The reductions in agricultural subsidies and protection agreed in the Uruguay Round. Only the figures for cutting export subsidies appear in the agreement.

Agriculture

The original GATT did apply to agricultural trade, but it contained loopholes. For

example, it allowed countries to use some non-tariff measures such as import quotas, and to subsidize. Agricultural trade became highly distorted, especially with the use of export subsidies, which would not normally have been allowed for industrial products. The Uruguay Round agreement is a significant first step towards order, fair competition and a less distorted sector. It is being implemented over a six-year period (10 years for developing countries) that began in 1995. 1st January, 1995 to 31st December, 2000. Participants have agreed to initiate negotiations for continuing the reform process one year before the end of the implementation period.

The objective of the Agriculture Agreement is to reform trade in the sector and to make policies more market-oriented. This would improve predictability and security for importing and exporting countries alike. The new rules and commitments apply to:

- Market access — various trade restrictions confronting imports;
- Domestic support — subsidies and other programmes, including those that raise or guarantee farm gate prices and farmers' incomes;
- Export subsidies and other methods used to make exports artificially competitive. The agreement does allow governments to support their rural economies, but preferably through policies that cause less distortion to trade. It also allows some flexibility in the way commitments are implemented. Developing countries do not have to cut their subsidies or lower their tariffs as much as developed countries and they are given extra time to complete their obligations. Special provisions deal with the interests of countries that rely on imports for their food supplies, and the least developed economies.

Distortion

The concept of "distortion" is used a lot when agricultural trade is discussed. Essentially, trade is distorted if prices are higher or lower than normal, and if quantities produced, bought, and sold are also higher or lower than normal — i.e. than the levels that would usually exist in a competitive market. For example, import carriers and domestic subsidies can raise crop prices on a country's internal market. The higher prices can encourage over-production, and if the surplus is to be sold on world markets, where prices are lower, then export subsidies have to be paid. When some countries subsidize and others do not, the result can be that the subsidizing countries are producing considerably more than they normally would. Governments usually give following reasons for supporting and protecting their farmers, even if this distorts agricultural trade:

- to make sure that enough food is produced to meet the country's needs,
- to shield farmers from the effects of the weather and swings in world prices to preserve rural society.

But the policies have often been expensive, and they have encouraged gluts leading to export subsidy wars. Countries with less money for subsidies have suffered. In negotiations, some countries have argued that trying to meet any of these objectives is counter-productive. Others have attempted to find ways of meeting the objectives without distorting trade too much. The newly committed tariffs and tariff quotas, covering all agricultural products, took effect in 1995. Uruguay Round participants agreed that developed countries would cut the tariffs over six

years. Developing countries would make cuts over 10 years. Several developing countries also used the option of offering ceiling tariff rates in cases where duties were not “bound” (i.e. committed under GATT or WTO regulations) before the Uruguay Round. Least developed countries do not have to cut their tariffs.

For products whose non-tariff restrictions have been converted to tariffs, governments are allowed to take special emergency actions (“safeguards”) in order to prevent swiftly falling prices or surges in imports from hurting their farmers. But the agreement specifies when and how those emergency actions can be introduced (for example, they cannot be used on imports within a tariff-quota).

Domestic support

The main complaint about policies, which support domestic prices, or subsidize production in some other way, is that they encourage overproduction. This squeezes out imports or leads to export subsidies and low-priced dumping on world markets. The Agriculture Agreement distinguishes between support programmes that stimulate production directly, and those that are considered to have no direct effect. Domestic policies that do have a direct effect on production and trade have to be cut back. WTO members have calculated how much support of this kind they were providing (using calculations known as “total aggregate measurement of support” or “Total AMS”) for the agricultural sector per year in the base years of 1986-88.

A separate agreement on food safety and animal and plant health standards (sanitary and phytosanitary measures) sets out the basic rules. It allows countries to set their own standards. But it also says regulations must be based on science. They should be applied only to the extent necessary to protect human, animal or plant life or health. And they should not arbitrarily or unjustifiably discriminate between countries where identical or similar conditions prevail.

Member countries are encouraged to use international standards, guidelines and recommendations where they exist. However, members may use measures, which result in higher standards if there is scientific justification. They can also set higher standards based on appropriate assessment of risks so long as the approach is consistent, not arbitrary. The agreement still allows countries to use different standards and different methods of inspecting products. So how can an exporting country be sure the practices it applies to its products are acceptable in an importing country? If an exporting country can demonstrate that the measures it applies on its exports achieve the same level of health protection as in the importing country, then the importing country is expected to accept the exporting country’s standards and methods.

The agreement includes provisions on control, inspection and approval procedures. Governments must provide advance notice of new or changed sanitary and phytosanitary regulations, and establish a national enquiry point to provide information. The agreement complements that on technical barriers to trade.

The least developed and those depending on food imports under the Agriculture Agreement, WTO members have to reduce their subsidized exports. But some countries have been highly dependent on supplies of cheap, subsidized food imported from the major industrialized nations. A special ministerial decision sets out objectives, and certain measures, for the provision of food aid and aid for agricultural development. It also refers to the possibility of assistance from the International

Monetary Fund and the World Bank to finance commercial food imports. Measures with minimal impact on trade can be used freely — they are in a “green box”. They include government services such as research, disease control, and infrastructure and food security. They also include payments made directly to farmers that do not stimulate production, such as certain forms of direct income support, assistance to help farmers restructure agriculture, and direct payments under environmental and regional assistance programmes. Also permitted, are certain direct payments to farmers where the farmers are required to limit production (sometimes called “blue box” measures), certain government assistance programmes to encourage agricultural and rural development in developing countries, and other support on a small scale when compared with the total value of the product or products supported.

Export Subsidies

The Agriculture Agreement prohibits export subsidies on agricultural products unless the subsidies are specified in a member’s lists of commitments. Where they are listed, the agreement requires WTO members to cut both the amount of money they spend on export subsidies and the quantities of exports that receive subsidies. Taking averages for 1986-90 as the base level, developed countries had agreed to cut the value of export subsidies by 36% over the six years starting in 1995 (24% over 10 years for developing countries). Developed countries had also agreed to reduce the quantities of subsidized exports by 21% over the six years (14% over 10 years for developing countries). Least developed countries do not need to make any cuts. During the six-year implementation period, developing countries are allowed under certain conditions to use subsidies to reduce the costs of marketing and transporting exports.

A TEXTILES MONITORING BODY (TMB)

The body supervises the agreement’s implementation. It consists of a chairman and 10 members acting in their personal capacity. It monitors actions taken under the agreement to ensure that they are consistent, and it reports to the Council on Trade in Goods, which reviews the operation of the agreement before each new step of the integration process. The Textiles Monitoring Body also deals with disputes under the Agreement on Textiles and Clothing. If they remain unresolved, the disputes can be brought to the WTO’s regular Dispute Settlement Body. Two dispute cases where the core arguments were based on the Textiles and Clothing Agreement have been taken to the Dispute Settlement Body for examination by a panel. They have subsequently been appealed.

Textiles and Clothing

Textiles, like agriculture, are one of the hardest-fought issues in the WTO, as it was in the former GATT system. It is now going through fundamental change under a 10-year schedule agreed in the Uruguay Round. The system of import quotas that has dominated the trade since the early 1960s is being phased out. From 1974 until the end of the Uruguay Round, the trade was governed by the Multifibre Arrangement (MFA) a framework for bilateral agreements or unilateral actions that established quotas limiting imports into countries whose domestic industries were facing serious damage from rapidly increasing imports. The quotas were the most visible feature. They conflicted with GATT’s general preference for customs tariffs instead of measures that restrict quantities. They were also exceptions to the GATT

principle of treating all trading partners equally because they specified how much the importing country was going to accept from individual exporting countries.

Since 1995, the WTO's Agreement on Textiles and Clothing (ATC) has taken over from the Multifibre Arrangement. By 2005, the sector is to be fully integrated into normal GATT rules. In particular, the quotas will come to an end, and importing countries will no longer be able to discriminate between exporters.

Textiles and clothing products are being returned to GATT rules over the 10-year period. This is happening gradually, in four steps, to allow time for both importers and exporters to adjust to the new situation. Some of these products were previously under quotas. Any quotas that were in place on 31 December 1994 were carried over into the new agreement. For products, which had quotas, the result of integration into GATT will be the removal of these quotas. The agreement states the percentage of products that have to be brought under GATT rules at each step. If any of these products came under quotas, then the quotas must be removed at the same time. The percentages are applied to the importing country's textiles and clothing trade levels in 1990. The agreement also says the quantities of imports permitted under the quotas should grow annually, and that the rate of expansion should increase at each stage. How fast that expansion should be is set out in a formula based on the growth rate that existed under the old Multifibre Arrangement.

Products brought under GATT rules at each of the first three stages must cover the four main types of textiles and clothing — tops and yarns; fabrics; made-up textile products; and clothing. Any other restrictions that did not come under the Multifibre Arrangement and did not conform with regular WTO agreements by 1996 have to be made to conform or phased out by 2005. If further cases of damage to the industry arise during the transition, the agreement allows additional restrictions to be imposed temporarily under strict conditions. These “transitional safeguards” are not the same as the safeguard measures normally allowed under GATT because they can be applied on imports from specific exporting countries. But the importing country has to show that its domestic industry is suffering serious damage or is threatened with serious damage. And it has to show that the damage is the result of two things: increased imports of the product in question from all sources, and a sharp and substantial increase from the specific exporting country.

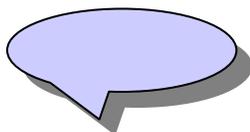
SERVICES: RULES FOR GROWTH

The General Agreement on Trade in Services (GATS) is the first ever set of multilateral, legally enforceable rules covering international trade in services. It was negotiated in the Uruguay Round. Like the agreements on goods, GATS operates on three levels — the main text containing general principles and obligations; annexes dealing with rules for specific sectors; and individual countries' specific commitments to provide access to their markets. Unlike in goods, GATS has a fourth special element lists showing where countries are temporarily not applying the “most-favoured-nation” principle of non-discrimination.

These commitments — like tariff schedules under GATT — are an integral part of the agreement. So are the temporary withdrawals of most-favoured-nation treatment. A WTO Council for Trade in Services oversees the operation of the agreement. Negotiations on commitments in four topics have taken place after the Uruguay Round.

GATS's 29 articles cover all services sectors. They contain the general obligations that all members have to apply. The agreement covers all internationally traded services. This includes all the different ways of providing an international service.

Basic Principles of GATS



- All services are covered by GATS
- Most-favoured-nation treatment applies to all services, except the one-off temporary exemptions
- National treatment applies in the areas where commitments are made
- Transparency in regulations, inquiry points
- Regulations have to be objective and reasonable
- International payments: normally unrestricted
- Individual countries' commitments: negotiated and bound
- Progressive liberalization: through further negotiations

General obligations and disciplines

The agreement covers all internationally-traded services — for example, banking, telecommunications, tourism, professional services, etc. It also defines four ways (or “modes”) of trading services:

Mode 1  Cross-Border Supply	Services supplied from one country to another (e.g. international telephone calls), officially known as “cross-border supply”.
Mode 2  Consumption Abroad	Consumers or firms making use of a service in another country (e.g. tourism), officially “consumption abroad”.
Mode 3  Commercial Presence	A foreign company setting up subsidiaries or branches to provide services in another country (e.g. foreign banks setting up operations in a country), officially “commercial presence”.
Mode 4  Presence of Natural Persons	Individuals travelling from their own country to supply services in another (e.g. fashion models or consultants), officially “presence of natural persons”

Most-favoured-nation (MFN) treatment Favour one, favour all. MFN means treating one's trading partners equally. Under GATS, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members. MFN applies to all services, but some special temporary exemptions have been allowed. National treatment — equal treatment for foreigners and one's own nationals — is treated differently for services. For goods (GATT) and intellectual property (TRIPS) it is a general principle. In GATS it only applies where a country has made a specific commitment, and exemptions are allowed.

Once a government has made a commitment to open a service sector to foreign competition, it must not normally restrict money being transferred out of the country as payment for services supplied ("current transactions") in that sector. The only exception is when there are balance- of-payments difficulties, and even then the restrictions must be temporary and subject to other limits and conditions.

Specific commitments

Individual countries' commitments to open markets in specific sectors — and how open those markets will be — are the outcome of negotiations. The commitments appear in "schedules" that list the sectors being opened, the extent of market access being given in those sectors (e.g. whether there are any restrictions on foreign ownership), and any limitations on national treatment (whether some rights granted to local companies will not be granted to foreign companies). These commitments are "bound": like bound tariffs, they can only be modified or withdrawn after negotiations with affected countries, which would probably lead to compensation. Because "unbinding" is difficult, the commitments are virtually guaranteed conditions for foreign exporters and importers of services and investors in the sector to do business.

Countries' commitments on market-opening

Each country lists specific commitments on service sectors and on activities within those sectors. The commitments guarantee access to the country's market in the listed sectors, and they spell out any limitations on market access and national treatment. For example, if a government commits itself to allow foreign banks to operate in its domestic market, that is a market access commitment. And if the government limits the number of licences it will issue, then that is a market access limitation. If it also says foreign banks are only allowed one branch while domestic banks are allowed numerous branches, that is an exception to the national treatment principle.

Market access

The lists of market access commitments (along with any limitations and exemptions from national treatment) negotiated as multilateral packages, though the bilateral bargaining sessions are needed to develop the packages. The commitments therefore contain the negotiated and guaranteed conditions for conducting international trade in services. If a recorded condition is to be changed for the worse, then the government has to give at least three months' notice and it has to negotiate compensation with affected countries. But the commitments can be improved at any time. They will be subject to further liberalization through the future negotiations already committed under GATS.

National treatment

National treatment means treating one's own nationals and foreigners equally. In services, it means that once a foreign company has been allowed to supply a service in one's country there should be no discrimination between the foreign and local companies. Under GATS, a country only has to apply this principle when it has made a specific commitment to provide foreigners access to its services market. It does not have to apply national treatment in sectors where it has made no commitment. Even in the commitments, GATS does allow some limits on national treatment. This contrasts with the way the national treatment principle is applied for goods — in that case, once a product has crossed a border and been cleared by customs it has to be given national treatment even if the importing country has not made any commitment under the WTO to bind the tariff rate.

INTELLECTUAL PROPERTY

Ideas and knowledge are an increasingly important part of trade. Most of the value of new medicines and other high technology products lies in the amount of invention, innovation, research, design and testing involved. Films, music recordings, books, computer software and on-line services are bought and sold because of the information and creativity they contain, not usually because of the plastic, metal or paper used to make them. Many products that used to be traded as low-technology goods or commodities now contain a higher proportion of invention and design in their value — for example, brand names or new varieties of plants. Creators can be given the right to prevent others from using their inventions, designs or other creations. These rights are known as “intellectual property rights”. They take a number of forms. For example — books, paintings and films come under copyright; inventions can be patented; brand names and product logos can be registered as trademarks; and so on.

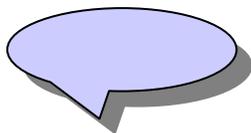
Types of Intellectual Property

The areas covered by the TRIPS agreement Copyright and related rights Trademarks, including service marks, Geographical indications, Industrial designs, Patents, Layout-designs (topographies) of integrated circuits, Undisclosed information including trade secrets.

The extent of protection and enforcement of these rights varied widely around the world; and as intellectual property became more important in trade, these differences became a source of tension in international economic relations. New internationally-agreed trade rules for intellectual property rights were seen as a way to introduce more order and predictability, and for disputes to be settled more systematically.

The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is an attempt to narrow the gaps in the way these rights are protected around the world, and to bring them under common international rules. When there are trade disputes over intellectual property rights, the WTO's dispute settlement system is now available.

The TRIPs agreement covers five broad issues:



- *How basic principles of the trading system and other international intellectual property agreements should be applied*
- *How to give adequate protection to intellectual property rights*
- *How countries should enforce those rights adequately in their own territories*
- *How to settle disputes on intellectual property between members of the WTO*
- *Special transitional arrangements during the period when the new system is being introduced.*

How to protect Intellectual Property

The second part of the TRIPS agreement looks at different kinds of intellectual property rights and how to protect them. The purpose is to ensure that adequate standards of protection exist in all member countries. Here the starting point is the obligations of the main international agreements of the World Intellectual Property Organization (WIPO) that already existed before the WTO was created:

- The Paris Convention for the Protection of Industrial Property (patents, industrial designs, etc)
- The Berne Convention for the Protection of Literary and Artistic Works (copyright).

Some areas are not covered by these conventions. In some cases, the standards of protection prescribed were thought inadequate. So the TRIPS agreement adds a significant number of new or higher standards.

Copyright

The TRIPS agreement ensures that computer programmes will be protected as literary works under the Berne Convention and outlines how databases should be protected. It also expands international copyright rules to cover rental rights. Authors of computer programmes and producers of sound recordings must have the right to prohibit the commercial rental of their works to the public. A similar exclusive right applies to films where commercial rental has led to widespread copying, affecting copyright-owners' potential earnings from their films. The agreement says performers must also have the right to prevent unauthorized recording, reproduction and broadcast of live performances (bootlegging) for no less than 50 years. Producers of sound recordings must have the right to prevent the unauthorized reproduction of recordings for a period of 50 years.

Trademarks

The agreement defines what types of signs must be eligible for protection as

trademarks, and what the minimum rights conferred on their owners must be. It says that service marks must be protected in the same way as trademarks used for goods. Marks that have become well known in a particular country enjoy additional protection.

Geographical indications

Place names are sometimes used to identify a product. Well-known examples include “Champagne”, “Scotch”, “Tequila”, and “Roquefort” cheese. Wine and spirits makers are particularly concerned about the use of place names to identify products, and the TRIPS agreement contains special provisions for these products. But the issue is also important for other types of goods.

Industrial designs

Under the TRIPS agreement, industrial designs must be protected for at least 10 years. Owners of protected designs must be able to prevent the manufacture, sale or importation of articles bearing or embodying a design, which is a copy of the protected design.

Patents

The agreement says patent protection must be available for inventions for at least 20 years. Patent protection must be available for both products and processes, in almost all fields of technology. Governments can refuse to issue a patent for an invention if its commercial exploitation is prohibited for reasons of public order or morality. They can also exclude diagnostic, therapeutic and surgical methods, plants and animals (other than microorganisms), and biological processes for the production of plants or animals (other than microbiological processes). Plant varieties, however, must be protectable by patents or by a special system (such as the breeder’s rights provided in the conventions of UPOV — the International Union for the Protection of New Varieties of Plants). The agreement describes the minimum rights that a patent owner must enjoy. But it also allows certain exceptions with a view to deal with abuse of patent by a patent-owner, the agreement empowers governments to issue “compulsory licenses”, allowing a competitor to produce the product or use the process under license. But this can only be done under certain conditions aimed at safeguarding the legitimate interests of the patent-holder. If a patent is issued for a production process, then the rights must extend to the product directly obtained from the process. Under certain conditions alleged infringer may be ordered by a court to prove that they have not used the patented process.

The difference between various types of Intellectual Property

Obviously, copyrights, patents, trademarks, etc apply to different types of creations or inventions. They are also treated differently. Patents, industrial designs, integrated circuit designs, geographical indications and trademarks have to be registered in order to receive protection. The registration includes a description of what is being protected — the invention, design, brand name, logo, etc — and this description is public information. Copyright and trade secrets are protected automatically according to specified conditions. They do not have to be registered, and therefore there is no need to disclose, for example, how copyrighted computer software is constructed. Other conditions may also differ, for example the length of time that each type of protection remains in force.

Integrated circuits layout designs

The basis for protecting integrated circuit designs (“topographies”) in the TRIPS agreement is the Washington Treaty on Intellectual Property in Respect of Integrated Circuits, which comes under the World Intellectual Property Organization. This was adopted in 1989 but has not yet entered into force. The TRIPS agreement adds a number of provisions: for example, protection must be available for at least 10 years. Undisclosed information and trade secrets and other types of “undisclosed information” which have commercial value must be protected against breach of confidence and other acts contrary to honest commercial practices. But reasonable steps must have been taken to keep the information secret. Test data submitted to governments in order to obtain marketing approval for new pharmaceutical or agricultural chemicals must also be protected against unfair commercial use. The owner of a copyright, patent or other form of intellectual property right can issue a license for someone else to produce or copy the protected trademark, work, invention, design, etc. The agreement recognizes that the terms of a licensing contract could restrict competition or impede technology transfer. It says that under certain conditions, governments have the right to take action to prevent anti-competitive licensing that abuses intellectual property rights. It also says governments must be prepared to consult each other on controlling anti-competitive licensing.

Enforcement

The TRIPs agreement says governments have to ensure that intellectual property rights can be enforced under their laws, and that the penalties for infringement are tough enough to deter further violations. The procedures must be fair and equitable, and not unnecessarily complicated or costly. They should not entail unreasonable time limits or unwarranted delays. People involved should be able to ask a court to review an administrative decision or to appeal a lower court’s ruling. The agreement describes in some detail how enforcement should be handled, including rules for obtaining evidence, provisional measures, injunctions, damages and other penalties. It says courts should have the right, under certain conditions, to order the disposal or destruction of pirated or counterfeit goods. Willful trademark counterfeiting or copyright piracy on a commercial scale should be criminal offences. Governments should make sure that intellectual property rights owners receive the assistance of customs authorities to prevent imports of counterfeit and pirated goods.

Transition arrangements

When the WTO agreements took effect on 1 January 1995, developed countries were given one year time to ensure that their laws and practices conform with the TRIPS agreement. Developing countries and (under certain conditions) transition economies are given five years. Least developed countries have 11 years. If a developing country did not provide product patent protection in a particular area of technology when the TRIPS Agreement came into force (1 January 1995), it has up to 10 years to introduce the protection. But for pharmaceutical and agricultural chemical products, the country must accept the filing of patent applications from the beginning of the transitional period, though the patent need not be granted until the end of this period. If the government allows the relevant pharmaceutical or agricultural chemical to be marketed during the transition period, it must — subject to

certain conditions — provide an exclusive marketing right for the product for five years, or until a product patent is granted, whichever is shorter subject to certain exceptions, the general rule is that obligations in the agreement apply to intellectual property rights that existed at the end of a country's transition period as well as to new ones. The Council for Trade-Related Aspects of Intellectual Property Rights monitors the working of the agreement and governments' compliance with it.

THE WORLD INTELLECTUAL PROPERTY ORGANIZATION

The World Intellectual Property Organization (WIPO) is an international organization dedicated to helping ensure that the rights of creators and owners of intellectual property are protected worldwide and that inventors and authors are, thus, recognized and rewarded for their ingenuity.

The roots of the World Intellectual Property Organization go back to 1833. That year marked the birth of the Paris Convention for the Protection of Industrial Property, the first major international treaty designed to help people of one country obtain protection in other countries for their intellectual creations in the form of industrial property rights.

The Paris Convention entered into force in 1884 with 14 member states, which set up an International Bureau to carry out administrative tasks.

In 1886, copyright entered the international arena with the Berne Convention for the Protection of Literary and Artistic Works. Like the Paris Convention, the Berne Convention set up an International Bureau to carry out administrative tasks.

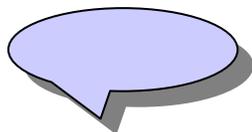
In 1893, these two small bureaus united to form an international organization called the United International Bureau for the Protection of Intellectual Property (best known by its French acronym, BIRPI). Based in Berne, Switzerland, with a staff of seven, this small organization was the predecessor of the World Intellectual Property Organization of today — a dynamic entity with more than 170 member states and a staff that includes some 650 people from around the world.

As the importance of intellectual property grew, the structure and form of the organization changed as well. In 1960, BIRPI moved from Berne to Geneva to be closer to the United Nations and other international organizations in that city. A decade later, following the entry into force of the Convention Establishing the World Intellectual Property Organization, BIRPI became WIPO, undergoing structural and administrative reforms and acquiring a secretariat answerable to the member states.

In 1974, WIPO became a specialized agency of the United Nations system of organizations, with a mandate to administer intellectual property matters recognized by the member states of the UN. WIPO expanded its role and further demonstrated the importance of intellectual property rights in the management of globalized trade in 1996 by entering into a cooperative agreement with the World Trade Organization.

In 1898, BIRPI administered only four international treaties. A century later, WIPO administers 21 treaties (two of those jointly with other international organizations) and carries out a rich and varied program of work.

Through its member states and secretariat, WIPO seeks to:



- *Harmonize national intellectual property legislation and procedures.*
- *Provide services for international applications for industrial property rights.*
- *Exchange intellectual property information.*
- *Provide legal and technical assistance to developing and other countries.*
- *Facilitate the resolution of private intellectual property disputes.*
- *Marshal information technology as a tool for storing, accessing, and using valuable intellectual property information.*

WIPO's program dedicated to identifying and exploring emerging intellectual property issues enables the timely development of responses to new challenges. Intellectual property issues have arisen and are assuming greater importance in respect of traditional knowledge and folklore as well as the conservation, preservation, management, sustainable utilization and benefit sharing of genetic resources. Extensive fact-finding and wide-ranging consultations by WIPO since 1998 culminated in the establishment by the member States, in late 2000 of the Intergovernmental Committee on Intellectual Property and Genetic Resources, Traditional Knowledge and Folklore. This new forum will discuss three primary themes, namely, intellectual property issues that arise in the context of (i) access to genetic resources and benefit-sharing; (ii) protection of traditional knowledge, whether or not associated with those resources; and (iii) the protection of expressions of folklore.

Among WIPO's key goals is the inclusion of all interested parties in dialogue. Over the years, WIPO has built an extensive - and ever growing - network of partners that support the Organization. Governments of some member States and other international organizations make financial and in-kind contributions for specific projects, such as training and advice, primarily for the benefit of developing countries.

In addition to its member States, WIPO also serves another important constituency, made up of the market sector. As industry and non-governmental organizations (NGOs) are of increasing significance in the Organization's work and financial well-being, WIPO continues to expand and enhance its relations with these groups. More than 172 NGOs have observer status at WIPO. At the same time, the Organization is reaching out to new groups which are becoming interested in intellectual property, ranging from small businesses to farmers, practitioners of traditional knowledge to the Internet community, performers and artists.

Two bodies of distinguished leaders and eminent experts also advise the Director General — the Policy Advisory Commission and the Industry Advisory Commission. These groups have discussions among their members and advise the Director General on, respectively, international policy issues concerning intellectual property and the needs of the private sector.

WIPO'S RELATIONS WITH THE WORLD TRADE ORGANIZATION

The World Trade Organization (WTO) was established with the successful conclusion of the Uruguay Round GATT Multilateral Trade Negotiations on April 15, 1994. One of the negotiated agreements is the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), which came into force on January 1, 1995. The TRIPS Agreement brought with it a new era in the protection and enforcement of intellectual property rights, enhancing the value of WIPO's program of work.

Provisions in the TRIPS Agreement concerning copyright and related rights, patents, trademarks, geographical indications, industrial designs, and layout designs of integrated circuits, directly complement international treaties and conventions which the secretariat of WIPO and its predecessor have serviced, in some cases, for more than 100 years.

On January 1, 1996, an Agreement between the World Intellectual Property Organization and the World Trade Organization entered into force. It provides for cooperation concerning the implementation of the TRIPS Agreement, such as notification of laws and regulations and legal-technical assistance and technical cooperation in favor of developing countries.

In July 1998 a joint initiative to help developing countries meet their TRIPS obligations in the year 2000 was launched. Assistance continues to be provided post-year 2000 deadline for many developing countries. Special attention will be given to those least-developed countries that need to meet their TRIPS obligations by 2006.

ANTI-DUMPING, SUBSIDIES

Binding tariffs and applying them equally to all trading partners (MFN) are key to the smooth flow of trade in goods. The WTO agreements uphold the principles, but they also allow exceptions — in some circumstances.

Three issues are important, namely

- Actions taken against dumping (selling at an unfairly low price);
- Subsidies and special “countervailing” duties to offset the subsidies;
- Emergency measures to limit imports temporarily, designed to “safeguard” domestic industries.

Agreement on the implementation of Article VI of the General Agreement on Tariffs and Trade 1994

GATT (Article 6) allows countries to take action against dumping. The Anti-Dumping Agreement clarifies and expands Article 6, and the two operate together. They allow countries to act in a way that would normally break the GATT principles of binding a tariff and not discriminating between trading partners — typically anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the “normal value” or to remove the injury to domestic industry in the importing country.

There are many different ways of calculating whether a particular product is

being dumped heavily or only lightly. The agreement narrows down the range of possible options. It provides three methods to calculate a product's "normal value". The main one is based on the price in the exporter's domestic market. When this cannot be used, two alternatives are available — the price charged by the exporter in another country, or a calculation based on the combination of the exporter's production costs, other expenses and normal profit margins. And the agreement also specifies how a fair comparison can be made between the export price and what would be a normal price. Calculating the extent of dumping on a product is not enough. Anti-dumping measures can only be applied if the dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. The investigation must evaluate all relevant economic factors that have a bearing on the state of the industry in question. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.

Anti-Dumping Actions

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be "dumping" the product. Is this unfair competition? Opinions differ, but many governments take action against dumping in order to defend their domestic industries. The WTO agreement does not pass judgment. Its focus is on how governments can or cannot react to dumping — it disciplines antidumping actions. The legal definitions are more precise, but broadly speaking the WTO agreement allows governments to act against dumping where there is genuine ("material") injury to the competing domestic industry. In order to do that the government has to be able to show that dumping is taking place, calculate the extent of dumping and show that the dumping is causing injury.

ANTI-DUMPING AND COUNTERVAILING DUTIES

Countervailing duties (CVD) together with anti-dumping (AD) measures are often linked. Many countries handle the two issues under a single law, apply similar process to deal with them and give a single authority responsible for investigations.

There are a number of similarities. The reaction to dumping and subsidies is often a special offsetting import tax (countervailing duty in the case of a subsidy). Like anti-dumping duty, countervailing duty is charged on products from specific countries and therefore it breaks the GATT principles of binding a tariff and treating trading partners equally (MFN). The agreements provide an escape clause, but they both also say that before imposing a duty, the importing country must conduct a detailed investigation that shows injury to domestic industry. But there are also fundamental differences, and these are reflected in the agreements. Dumping is an action by a company. With subsidies, it is the government or a government agency that acts, either by paying out subsidies directly or by requiring companies to subsidize certain customers. But the WTO is an organization of countries and their governments. The WTO does not deal with companies and cannot regulate companies' actions such as dumping. Therefore the Anti-Dumping Agreement only concerns the actions governments may take against dumping. With subsidies, governments act on both sides: they subsidize and they act against each others'

subsidies. Therefore, the subsidies agreement disciplines both the subsidies and the reactions.

The present rules revise the Tokyo Round (1973-79) code on anti-dumping measures and are a result of the Uruguay Round (1986-94) negotiations. The Tokyo Round code was not signed by all GATT members; the Uruguay Round version is part of the WTO agreement and applies to all members. The WTO Anti-Dumping Agreement introduced these modifications — more detailed rules for calculating the amount of dumping, more detailed procedures for initiating and conducting anti-dumping investigations, and rules on the implementation and duration.

The agreement says member countries must inform the Committee on Anti-Dumping Practices about all preliminary and final antidumping actions, promptly and in detail. They must also report on all investigations twice a year. When differences arise, members are encouraged to consult each other. They can also use the WTO's dispute settlement procedure.

SUBSIDIES AND COUNTERVAILING MEASURES

This agreement does two things — it disciplines the use of subsidies, and it regulates the actions countries can take to counter the effects of subsidies. It says a country can use the WTO's dispute settlement procedure to seek the withdrawal of the subsidy or the removal of its adverse effects. Or the country can launch its own investigation and ultimately charge extra duty (known as "countervailing duty") on subsidized imports that are found to be hurting domestic producers. The agreement builds on the Tokyo Round Subsidy Code. Unlike its predecessor, the present agreement contains a definition of subsidy. It also introduces the concept of a "specific" subsidy i.e. a subsidy available only to an enterprise, industry, group of enterprises, or group of industries in the country (or state, etc) that gives the subsidy. The disciplines set out in the agreement only apply to specific subsidies. They can be domestic or export subsidies.

Prohibited subsidies: subsidies that require recipients to meet certain export targets, or to use domestic goods instead of imported goods, are prohibited because they are specifically designed to distort international trade, and are therefore likely to hurt other countries' trade. They can be challenged under the WTO dispute settlement procedure where they are handled under an accelerated timetable. If the dispute settlement procedure confirms that the subsidy is prohibited, it must be withdrawn immediately. Otherwise, the complaining country can take counter measures. If domestic producers are hurt by imports of subsidized products, countervailing duty can be imposed.

Actionable subsidies: The complaining country has to show that the subsidy has an adverse effect on its interests. Otherwise the subsidy is permitted. The agreement defines three types of damage they can cause. One country's subsidies can hurt a domestic industry in an importing country. They can hurt rival exporters from another country when the two compete in third markets. And domestic subsidies in one country can hurt exporters trying to compete in the subsidizing country's domestic market.

Non-actionable subsidies: these can either be non-specific subsidies, or

specific subsidies for industrial research and pre-competitive development activity, assistance to disadvantaged regions, or certain types of assistance for adapting existing facilities to new environmental laws or regulations. Non-actionable subsidies cannot be challenged in the WTO's dispute settlement procedure, and countervailing duty cannot be imposed on subsidized imports. There are detailed rules for deciding whether a product is being subsidized, criteria for determining whether imports of subsidized products are hurting ("causing injury to") domestic industry, procedures for initiating and conducting investigations, and rules on the implementation and duration (normally five years) of countervailing measures.

Agreement on Safeguards

A WTO member may restrict imports of a product temporarily (take "safeguard" actions) if its domestic industry is injured or threatened with injury caused by a surge in imports. Here, the injury has to be serious. Safeguard measures were always available under GATT (Article 19). However, they were infrequently used, some governments preferring to protect their domestic industries through "grey area" measures — using bilateral negotiations outside GATT's auspices they persuaded exporting countries to restrain exports "voluntarily" or to agree to other means of sharing markets. Industries or companies may request safeguard action by their government. The WTO agreement sets out requirements for safeguard investigations by national authorities. The emphasis is on transparency and adherence to established rules and practices — avoiding arbitrary methods. The authorities conducting investigations have to announce publicly when hearings are to take place and provide other appropriate means for interested parties to present evidence. The evidence must include arguments on whether a measure is in the public interest. The agreement sets out criteria for assessing whether "serious injury" is being caused or threatened, and the factors which must be considered in determining the impact of imports on the domestic industry. When imposed, a safeguard measure should be applied only to the extent necessary to prevent or remedy serious injury and to help the industry concerned to adjust. Where quantitative restrictions (quotas) are imposed, they normally should not reduce the quantities of imports below the annual average for the last three representative years for which statistics are available, unless clear justification is given that a different level is necessary to prevent or remedy serious injury. In principle, safeguard measures cannot be targeted at imports from a particular country. However, the agreement does describe how quotas can be allocated among supplying countries, including in the exceptional circumstance where the WTO agreement broke new ground. A safeguard measure should not last more than four years, although this can be extended up to eight years, subject to a determination by competent national authorities that the measure is needed and that there is evidence the industry is adjusting. Measures imposed for more than a year must be progressively liberalized. When a country restricts imports in order to safeguard its domestic producers, in principle it must give something in return. The agreement says the exporting country (or exporting countries) can seek compensation through consultations. If no agreement is reached the exporting country can retaliate by taking equivalent action. The WTO's Safeguards Committee oversees the operation of the agreement and is responsible for the surveillance of members' commitments. Governments have to report each phase of a safeguard investigation and related decision-making, and the committee reviews these reports.

NON-TARIFF BARRIERS

Finally, a number of agreements deal with various technical, bureaucratic or legal issues that could involve hindrances to trade. These include:

- technical regulations and standards
- import licensing
- rules for the valuation of goods at customs
- preshipment inspection: further checks on imports
- investment measures

Technical Regulations and Standards

Technical regulations and industrial standards are important, but they vary from country to country. Having too many different standards makes life difficult for producers and exporters. If the standards are set arbitrarily, they could be used as an excuse for protectionism. Standards can become obstacles to trade. The Agreement on Technical Barriers to Trade tries to ensure that regulations, standards, testing and certification procedures do not create unnecessary obstacles. The WTO's version is a modification of the code negotiated in the 1973- 79 Tokyo Round. The agreement recognizes countries' rights to adopt the standards they consider appropriate, for example, for human, animal or plant life or health, for the protection of the environment or to meet other consumer interests. Moreover, members are not prevented from taking measures necessary to ensure their standards are met. In order to prevent too much diversity, the agreement encourages countries to use international standards where these are appropriate, but it does not require them to change their levels of protection as a result.

AGREEMENT ON IMPORT LICENSING PROCEDURES

The agreement sets out a code of good practice for the preparation, adoption and application of standards by central government bodies. It also includes provisions describing how local government and non-governmental bodies should apply their own regulations — normally they should use the same principles as apply to central governments. The agreement says the procedures used to decide whether a product conforms with national standards have to be fair and equitable. It discourages any methods that would give domestically produced goods an unfair advantage. The agreement also encourages countries to recognize each other's testing procedures. That way, a product can be assessed to see if it meets the importing country's standards through testing in the country where it is made. Manufacturers and exporters need to know what the latest standards are in their prospective markets. To help ensure that this information is made available conveniently, all WTO member governments are required to establish national enquiry points.

Import licensing

Although less widely used now than in the past, import licensing systems are subject to disciplines in the WTO. The Agreement on Import Licensing Procedures says import licensing should be simple, transparent and predictable. For example,

the agreement requires governments to publish sufficient information for traders to know how and why the licenses are granted.

AGREEMENT ON TECHNICAL BARRIERS TO TRADE

The agreement offers guidance on how governments should assess applications for licenses. Some licenses are issued automatically if certain conditions are met. The agreement sets criteria for automatic licensing so that the procedures used do not restrict trade. Other licenses are not issued automatically. Here, the agreement tries to minimise the importers' burden in applying for licences, so that the administrative work does not in itself restrict or distort imports. The agreement says the agencies handling licensing should not normally take more than 30 days to deal with an application — 60 days when all applications are considered at the same time.

Agreement on Pre-shipment Inspection

A further check on imports, pre shipment inspection is the practice of employing specialized private companies (or "independent entities") to check shipment details — essentially price, quantity and quality of goods ordered overseas. Used by governments of developing countries, the purpose is to safeguard national financial interests (prevention of capital flight and commercial fraud as well as customs duty evasion, for instance) and to compensate for inadequacies in administrative infrastructures.

The agreement recognizes that GATT principles and obligations apply to the activities of pre shipment inspection agencies mandated by governments. The obligations placed on governments, which use pre shipment inspections, include non-discrimination, transparency, protection of confidential business information, avoidance of unreasonable delay, the use of specific guidelines for conducting price verification and the avoidance of conflicts of interest by the inspection agencies. The obligations of exporting members towards countries using pre shipment

Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994

The agreement establishes an independent review procedure. It is administered jointly by an organization representing inspection agencies and an organization representing exporters. Its purpose is to resolve disputes between an exporter and an inspection agency.

RULES OF ORIGIN

"Rules of origin" are the criteria used to define where a product was made. They are an essential part of trade rules because a number of policies discriminate between exporting countries: quotas, preferential tariffs, anti-dumping actions, countervailing duty (charged to counter export subsidies), and more. Rules of origin are also used to compile trade statistics, and for "made in" labels that are attached to products. This first-ever agreement on the subject requires WTO members to ensure that their rules of origin are transparent; that they do not have restricting, distorting or disruptive effects on international trade; that they are administered in a consistent, uniform, impartial and reasonable manner; and that they are based on a positive standard (in other words, they should state what does confer origin rather than what

does not). For the longer term, the agreement aims for common (“harmonized”) rules of origin among all WTO members, except in some kinds of preferential trade — for example, countries setting up a free trade area are allowed to use different rules of origin for products traded under their free trade agreement.

Investment measures

The Agreement on Trade-Related Investment Measures (TRIMS) applies only to measures that affect trade in goods. It recognizes that certain measures can restrict and distort trade, and states that no member shall apply any measure that discriminates against foreigners or foreign products (i.e. violates “national treatment” principles in GATT). It also outlaws investment measures that lead to restrictions in quantities (violating another principle in GATT). An illustrative list of TRIMS agreed to be inconsistent with these GATT articles is appended to the agreement. The list includes measures, which require particular levels of local procurement by an enterprise (“local content requirements”). It also discourages measures, which limit a company’s imports or set targets for the company to export (“trade balancing requirements”). Under the agreement, countries must inform the WTO and fellow-members of all investment measures that do not conform to the agreement.*

PLURILATERALS

For the most part, all WTO members subscribe to all WTO agreements. After the Uruguay Round, however, there remained four agreements, originally negotiated in the Tokyo Round, which have a narrower group of signatories and are known as “plurilateral agreements”. All other Tokyo Round agreements became multilateral obligations (i.e. obligations for all WTO members) when the World Trade Organization was established in 1995.

The four “plurilateral agreements” were:

- Trade in civil aircraft
- Government procurement
- Dairy products
- Bovine meat.

The bovine meat and dairy agreements were terminated in 1997.

TRADE POLICY REVIEWS

Individuals and companies involved in trade have to know as much as possible about the conditions of trade. It is therefore fundamentally important that regulations and policies are transparent. In the WTO, this is achieved in two ways: governments have to inform the WTO and fellow- members of specific measures, policies or laws through regular “notifications”; and the WTO conducts regular reviews of individual countries’ trade policies — the trade policy reviews. These reviews are part of the Uruguay Round agreement, but they began several years before the round ended — they were an early result of the negotiations.

* The agreement establishes a Committee on TRIMS to Monitor the implementation of these commitments.

What are the objectives of trade policy review?

The objectives of trade policy review are given hereunder:

- *To increase the transparency and understanding of countries' trade policies and practices, through regular monitoring*
- *To improve the quality of public and intergovernmental debate on the issues*
- *To enable a multilateral assessment of the effects of policies on the world trading system.*

**SETTLEMENT OF DISPUTES**

Without a means of settling disputes, the rules-based system would be worthless because the rules could not be enforced. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. The system is based on clearly defined rules, with timetables for completing a case. First rulings are made by a panel and endorsed (or rejected) by the WTO's full membership. Appeals based on points of law are possible. However, the point is not to make rulings. The priority is to settle disputes, through consultations if possible. WTO members have agreed that if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally. That means abiding by the agreed procedures, and respecting judgments. Typically, a dispute arises when one country adopts a trade policy measure or takes some action that one or more fellow-WTO members considers to be breaking the WTO agreements, or to be a failure to live up to obligations.

A procedure for settling disputes existed under the old GATT, but it had no fixed timetables, rulings were easier to block, and many cases dragged on for a long time inconclusively. The Uruguay Round agreement introduced a more structured process with more clearly defined stages in the procedure. It introduced greater discipline for the length of time a case should take to settle, with flexible deadlines set in various stages of the procedure. The agreement emphasizes that prompt settlement is essential if the WTO is to function effectively. If a case runs its full course to a first ruling, it should not normally take more than about one year — 15 months if the case is appealed. The agreed time limits are flexible, and if the case is considered urgent, the case should take three months less. The Uruguay Round agreement also made it impossible for the country losing a case to block the adoption of the ruling.

How are disputes settled?

Settling disputes is the responsibility of the Dispute Settlement Body (DSB)— the sole authority to establish "panels" of experts to consider the case, and to accept or reject the panels' findings or the results of an appeal. It monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling.

Panels

Panels are like tribunals. But unlike a normal tribunal, the panelists are usually

chosen in consultation with the countries in dispute. Only in the case of disagreement between the parties, the WTO director general appoint them. Panels consist of three (occasionally five) experts from different countries who examine the evidence and decide who is right and who is wrong. The panel's report is passed to the Dispute Settlement Body, which can only reject the report by consensus. Panelists for each case can be chosen from a permanent list of well-qualified candidates, or from elsewhere. They serve in their individual capacities. They cannot receive instructions from any government.

Appeals

Either side can appeal a panel's ruling. Sometimes both sides do so. Appeals have to be based on points of law such as legal interpretation

- they cannot reexamine existing evidence or examine new evidence. Three members of a permanent seven-member Appellate Body set up by the Dispute Settlement Body and broadly representing the range of WTO memberships hear each appeal. Members of the Appellate Body have four-year terms. They have to be individuals with recognized standing in the field of law and international trade, not affiliated with any government.
- The dispute settlement agreement stresses "prompt compliance with recommendations or rulings of the DSB [Dispute Settlement Body] is essential in order to ensure effective resolution of disputes to the benefit of all Members". If the country that is the target of the complaint loses, it must follow the recommendations of the panel report or the appeals report. It must state its intention to do so at a Dispute Settlement Body meeting held within 30 days of the report's adoption. If complying with the recommendation immediately proves impractical, the member will be given.

Voting under WTO Agreement

The WTO continues GATT's tradition of making decisions not by voting but by consensus. This allows all members to ensure that their interests are properly considered even though, on occasion, they may decide to join a consensus in the overall interests of the multilateral trading system. Where consensus is not possible, the WTO agreement allows for voting — a vote being won with a majority of the votes cast and on the basis of "one country, one vote".

Specific Situations Involving Voting

- An interpretation of any of the multilateral trade agreements can be adopted by a majority of three-quarters of WTO members.
- The Ministerial Conference can waive an obligation imposed on a particular member by a multilateral agreement, also through a three-quarters majority.
- Decisions to amend provisions of the multilateral agreements can be adopted through approval either by all members or by a two-thirds majority depending on the nature of the provision concerned. But the amendments only take effect for those WTO members, which accept them.

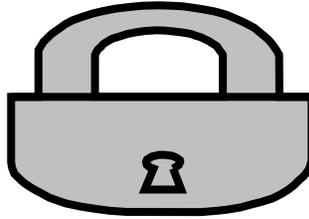
A decision to admit a new member is taken by a two-third majority in the Ministerial Conference, or the General Council in between conferences.

LESSON ROUND UP



- The World Trade Organization (WTO) is the only international body dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground-rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits.
- Most Favour Nation suggests some kind of special treatment for one particular country, but in the WTO it actually means non-discrimination — treating virtually everyone equally.
- National Treatment principle says that imported and locally produced goods should be treated equally, at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents.
- The General Agreement on Trade in Services (GATS) is the first ever set of multilateral, legally enforceable rules covering international trade in services.
- TRIPS agreement covers copyright and related rights, Trademarks, including service marks, Geographical indications, Industrial designs, Patents, Layout-designs (topographies) of integrated circuits, Undisclosed information including trade secrets.
- “Rules of origin” are the criteria used to define where a product was made. They are an essential part of trade rules because a number of policies discriminate between exporting countries: quotas, preferential tariffs, anti-dumping actions, countervailing duty (charged to counter export subsidies), and more. Rules of origin are also used to compile trade statistics, and for “made in” labels that are attached to products.

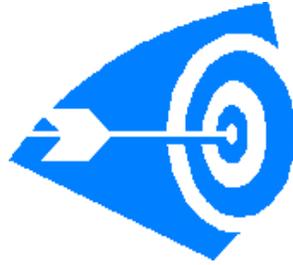
SELF TEST QUESTIONS



1. Enumerate the three key documents produced by the WTO Doha ministerial conference.
2. Elucidate the concept of 'Most favoured Nation' as understood in WTO?
3. What are the different kinds of Intellectual Property rights protected by TRIPS?
4. What are 'Rules of Origin' and why are they considered to be an essential part of trade rules?
5. What do you mean by Anti-Dumping Actions? Briefly discuss similarities and differences between anti-dumping and countervailing duties.

STUDY XIII

**INTERNATIONAL TRADE AND TREATIES
(WTO - MINISTERIAL CONFERENCE)**



The object of the study lesson is to enable the students to understand the discussion and progress on various issues under WTO – Ministerial Conferences

- Singapore Ministerial Conference, 1996
- Geneva Ministerial Conference, 1998
- Seattle Ministerial Conference, 1999
- Doha Ministerial Conference, 2001
- Cancun Ministerial Conference, 2003
- Hong Kong Ministerial Conference, 2005
- Geneva Ministerial Conference, 2009

INTRODUCTION

The WTO is a member driven, consensus based organisation. The major decisions are taken by members as a whole, either by ministers or by their ambassadors or delegates. The Ministerial Conference – the highest decision making body of WTO has to meet at least every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements. WTO rules impose disciplines on countries' policies that are the outcome of negotiations among WTO members. The rules are enforced by the members themselves under agreed procedures that they negotiated, including the possibility of trade sanctions. But those sanctions are imposed by member countries, and authorized by the membership as a whole.

Following Ministerial Conferences have been held so far –



- I. First Ministerial Conference at Singapore on December 9-13, 1996.*
- II. Second Ministerial Conference at Geneva on May 18-20, 1998.*
- III. Third Ministerial Conference at Seattle on November 30 – December 3, 1999.*
- IV. Fourth Ministerial Conference at Doha on November 9-13, 2001.*
- V. Fifth Ministerial Conference at Cancun on September 10-14, 2003.*
- VI. Sixth Ministerial Conference at Hong Kong on December 13-18, 2005.*
- VII. Seventh Ministerial Conference at Geneva from 30 November to 2 December 2009.*

The major provisions of Declarations adopted at the Ministerial Conferences held so far are given below :

SINGAPORE MINISTERIAL CONFERENCE, 1996

Ministerial Declaration adopted on December 13, 1996

In terms of Article IV of the Agreement establishing the World Trade Organisation the Ministers met in Singapore from 9 to 13 December, 1996 for the first regular biennial meeting of the WTO, to further strengthen the WTO as a forum for negotiation, the continuing liberalization of trade within a rule-based system, and the multilateral review and assessment of trade policies, and in particular to:

- assess the implementation of commitments under the WTO Agreements and decisions;
- review the ongoing negotiations and Work Programme;
- examine developments in world trade; and
- address the challenges of an evolving world economy.

Integration of Economies – Opportunities and Challenges

Members felt that the scope and pace of change in the international economy, including the growth of trade in services and direct investment, and the increasing integration of economies offer unprecedented opportunities for improved growth, job creation, and development. These developments require adjustment by economies and societies themselves. However, they also pose challenges to the trading system. The Ministers commit themselves to address these challenges.

Core Labour Standards

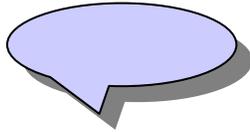
Ministers renewed their commitment to the observance of internationally recognized core labour standards. Recognising that the International Labour Organization (ILO) is the competent body to set and deal with these standards, the Ministers affirmed their support for its work in promoting them. The Ministers, however, rejected the use of labour standards for protectionist purposes, but agreed that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question.

Marginalization

Ministers committed themselves to address the problem of marginalization for least-developed countries, and the risk of it for certain developing countries and to continue to work for greater coherence in international economic policy-making and for improved coordination between the WTO and other agencies in providing technical assistance.

ROLE OF WTO

In pursuit of the goal of sustainable growth and development for the common good, the Ministers envisaged a world where trade flows freely and renewed their commitment to:



- *a fair, equitable and more open rule-based system;*
- *progressive liberalization and elimination of tariff and non-tariff barriers to trade in goods;*
- *progressive liberalization of trade in services;*
- *rejection of all forms of protectionism;*
- *elimination of discriminatory treatment in international trade relations;*
- *integration of developing and least-developed countries and economies in transition into the multilateral system; and*
- *the maximum possible level of transparency.*

Regional Agreements

Ministers noted that trade relations of WTO Members are being increasingly influenced by regional trade agreements, which have expanded vastly in number, scope and coverage and such initiatives can promote further liberalization and may assist least-developed, developing and transition economies in integrating into the international trading system. In this context, Ministers noted the importance of existing regional arrangements involving developing and least-developed countries. The expansion and extent of regional trade agreements make it important to analyse whether the system of WTO rights and obligations as it relates to regional trade

agreements needs to be further clarified. Reaffirming the primacy of the multilateral trading system, which includes a framework for the development of regional trade agreements, the Ministers renewed their commitment to –

- ensure that regional trade agreements are complementary to it and consistent with its rules.
- facilitate mutually supportive processes of global and regional trade liberalization.

Dispute Settlement

The Dispute Settlement Understanding (DSU) offers a means for the settlement of disputes among Members that is unique in international agreements. The Ministers believed that its impartial and transparent operation to be of fundamental importance in assuring the resolution of trade disputes, and in fostering the implementation and application of the WTO agreements. The Ministers believed that the DSU has worked effectively during its first two years and also noted the role that several WTO bodies have played in helping to avoid disputes. The Ministers renewed their determination to abide by the rules and procedures of the DSU and other WTO agreements in the conduct of their trade relations and the settlement of disputes. The Ministers expressed their confidence that longer experience with the DSU, including the implementation of panel and appellate recommendations, will further enhance the effectiveness and credibility of the dispute settlement system.

Implementation

Ministers attached high priority to full and effective implementation of the WTO Agreement in a manner consistent with the goal of trade liberalization.

Developing Countries

In respect of importance of integration of developing countries in the multilateral trading system for their economic development and for global trade expansion, the Ministers recalled that the WTO Agreement embodies provisions conferring differential and more favourable treatment for developing countries, including special attention to the particular situation of least-developed countries and acknowledged the fact that developing country Members have undertaken significant new commitments, both substantive and procedural, and recognized the range and complexity of the efforts that they are making to comply with them. In order to assist developing countries in these efforts, including those with respect to notification and legislative requirements, the Ministers decided to improve the availability of technical assistance under the agreed guidelines.

Least-Developed Countries

Expressing concern over the problems of the least-developed countries, the Ministers agreed to:

- a Plan of Action, including provision for taking positive measures, for example duty-free access, on an autonomous basis, aimed at improving their overall capacity to respond to the opportunities offered by the trading system;

- to give operational content to the Plan of Action, for example, by enhancing conditions for investment and providing predictable and favourable market access conditions for LDCs' products, to foster the expansion and diversification of their exports to the markets of all developed countries; and in the case of relevant developing countries in the context of the Global System of Trade Preferences; and
- organize a meeting with UNCTAD and the International Trade Centre, with the participation of aid agencies, multilateral financial institutions and least-developed countries to foster an integrated approach to assisting these countries in enhancing their trading opportunities.

Textiles and Clothing

Confirming their commitment to full and faithful implementation of the provisions of the Agreement on Textiles and Clothing (ATC), the Ministers stressed the importance of the integration of textile products, as provided for in the ATC, into GATT 1994 under its strengthened rules and disciplines because of its systemic significance for the rule-based, non-discriminatory trading system and its contribution to the increase in export earnings of developing countries.

Trade and Environment

Ministers noted that the Committee on Trade and Environment has made an important contribution towards fulfilling its Work Programme. The Committee has been examining and will continue to examine, *inter alia*, the scope of the complementarities between trade liberalization, economic development and environmental protection. Full implementation of the WTO Agreements will make an important contribution to achieving the objectives of sustainable development. The work of the Committee has underlined the importance of policy coordination at the national level in the area of trade and environment. In this connection, the work of the Committee has been enriched by the participation of environmental as well as trade experts from Member governments and the further participation of such experts in the Committee's deliberations would be welcomed.

Services Negotiations

Ministers noted that the fulfilment of the objectives agreed at Marrakesh for negotiations on the improvement of market access in services - in financial services, movement of natural persons, maritime transport services and basic telecommunications - has proved to be difficult. The results have been below expectations. In three areas, it has been necessary to prolong negotiations beyond the original deadlines. The Ministers expressed their determination to obtain a progressively higher level of liberalization in services on a mutually advantageous basis with appropriate flexibility for individual developing country Members, as envisaged in the Agreement, in the continuing negotiations. In this context, the Ministers looked forward to full MFN agreements based on improved market access commitments and national treatment and accordingly to—

- achieve a successful conclusion to the negotiations on basic telecommunications in February 1997; and

- resume financial services negotiations in April 1997 with the aim of achieving significantly improved market access commitments with a broader level of participation in the agreed time frame.

With the same broad objectives in mind, the Ministers also looked forward to a successful conclusion of the negotiations on Maritime Transport Services in the next round of negotiations on services liberalization. In professional services, the Ministers aimed at completing the work on the accountancy sector by the end of 1997, and to continue to develop multilateral disciplines and guidelines.

ITA and Pharmaceuticals

Taking note that a number of Members have agreed on a Declaration on Trade in Information Technology Products, the Ministers welcomed the initiative taken by a number of WTO Members and other States or separate customs territories which have applied to accede to the WTO, who have agreed to tariff elimination for trade in information technology products on an MFN basis as well as the addition by a number of Members of over 400 products to their lists of tariff-free products in pharmaceuticals.

Work Programme and Built-in Agenda

Bearing in mind that an important aspect of WTO activities is a continuous overseeing of the implementation of various agreements, a periodic examination and updating of the WTO Work Programme is a key to enable the WTO to fulfil its objectives. In this context, the Ministers endorsed the reports of the various WTO bodies and agreed to a process of analysis and exchange of information, where provided for in the conclusions and recommendations of the relevant WTO bodies, on the Built-in Agenda issues, to allow Members to better understand the issues involved and identify their interests before undertaking the agreed negotiations and reviews. The Ministers thus agreed that:

- the time frames established in the Agreements will be respected in each case;
- the work undertaken shall not prejudice the scope of future negotiations where such negotiations are called for; and
- the work undertaken shall not prejudice the nature of the activity agreed upon (i.e. negotiation or review).

Investment and Competition

Having regard to the existing WTO provisions on matters related to investment and competition policy and the built-in agenda in these areas, including the TRIMs Agreement, and on the understanding that the work undertaken shall not prejudice whether negotiations will be initiated in the future, the Ministers agreed to:

- establish a working group to examine the relationship between trade and investment; and
- establish a working group to study issues raised by Members relating to the interaction between trade and competition policy, including anti-competitive practices, in order to identify any areas that may merit further consideration in the WTO framework.

Transparency in Government Procurement

In respect of transparency in Government procurement the Ministers agreed to:

- establish a working group to conduct a study on transparency in government procurement practices, taking into account national policies, and, based on this study, to develop elements for inclusion in an appropriate agreement; and
- direct the Council for Trade in Goods to undertake exploratory and analytical work, drawing on the work of other relevant international organizations, on the simplification of trade procedures in order to assess the scope for WTO rules in this area.

Singapore Ministerial Declaration on Trade in Information Technology Products, December 13, 1996

Ministers, representing Members of the WTO and States or separate customs territories in the process of acceding to the WTO, which have agreed in Singapore on the expansion of world trade in information technology products and which account for well over 80 per cent of world trade in these products ("parties") declared that each party's trade regime should evolve in a manner that enhances market access opportunities for information technology products, each party shall bind and eliminate customs duties and other duties and charges of any kind, within the meaning of Article II:1(b) of the General Agreement on Tariffs and Trade 1994, with respect to the following:

- (a) all products classified (or classifiable) with Harmonized System (1996) ("HS") headings listed in Attachment A to the Annex to the Declaration; and
- (b) all products specified in Attachment B to the Annex to the Declaration, whether or not they are included in Attachment A;

through equal rate reductions of customs duties beginning in 1997 and concluding in 2000, recognizing that extended staging of reductions and, before implementation, expansion of product coverage may be necessary in limited circumstances.

Ministers expressed satisfaction about the large product coverage and instructed their respective officials to make good faith efforts to finalize plurilateral technical discussions in Geneva on the basis of these modalities, and to complete this work by January 31, 1997, so as to ensure the implementation of this Declaration by the largest number of participants.

Ministers also invited the Ministers of other Members of the WTO, and States or separate customs territories in the process of acceding to the WTO, to provide similar instructions to their respective officials, so that they may participate in the technical discussions and participate fully in the expansion of world trade in information technology products.

GENEVA MINISTERIAL CONFERENCE, 1998

Ministerial Declaration adopted on May 20, 1998

Ministers underlined the crucial importance of the multilateral rule-based trading

system, reaffirmed the commitments and assessments made at Singapore, and noted that the work under existing agreements and decisions has resulted in significant new steps forward since the last Ministerial Conference. In particular, the Ministers welcomed the successful conclusion of the negotiations on basic telecommunications and financial services; took note of the implementation of the Information Technology Agreement and renewed their commitment to achieve progressive liberalization of trade in goods and services.

Ministers rejected the use of any protectionist measures and agreed to work together in the WTO as in the IMF and the World Bank to improve the coherence of international economic policy-making with a view to maximizing the contribution that an open, rule-based trading system can make to fostering stable growth for economies at all levels of development.

Ministers recognized the importance of enhancing public understanding of the benefits of the multilateral trading system in order to build support for it and agreed to work towards this end. In this context, Ministers considered ways to improve the transparency of WTO operations and to continue to improve their efforts towards the objectives of sustained economic growth and sustainable development.

Renewing their commitment to ensuring that the benefits of the multilateral trading system are extended as widely as possible, Ministers recognized the need for the system to make its own contribution in response to the particular trade interests and development needs of developing-country Members.

Expressing their concern over the marginalization of least-developed countries and certain small economies, Ministers recognized urgent need to address this issue which has been compounded by the chronic foreign debt problem facing many of them. Committing themselves to continue to improve market access conditions for products exported by the least-developed countries on as broad and liberal a basis as possible, Ministers urged members to implement the market-access commitments undertaken at the High-Level Meeting.

GENEVA MINISTERIAL DECLARATION ON GLOBAL ELECTRONIC COMMERCE, MAY 20, 1998

Recognizing that global electronic commerce is growing and creating new opportunities for trade, the Ministers declared that the General Council shall, by its next meeting in special session, establish a comprehensive work programme to examine all trade-related issues relating to global electronic commerce, including those identified by Members. The work programme will involve the relevant World Trade Organization ("WTO") bodies, take into account the economic, financial, and development needs of developing countries. Without prejudice to the outcome of the work programme or the rights and obligations of Members under the WTO Agreements, Ministers also declared that Members will continue their current practice of not imposing customs duties on electronic transmissions.

SEATTLE MINISTERIAL CONFERENCE, 1999

The Third WTO Ministerial Conference was held in Seattle, Washington, USA between November 30 and December 3, 1999. The meeting was suspended without adopting any declaration. The suspension of talks, however, was not un-precedented

in the history of multilateral trading system. The previous illustrations of Ministerial talks which were suspended include – the Uruguay Round Mid Term Review, Montreal, December 1988; and the Brussel Ministerial Meeting, December 1990. Mike Moore, the then Director General of WTO said that despite the temporary setback in Seattle, objectives remain unchanged—

- (i) To continue to negotiate the progressive liberalisation of international trade;
- (ii) To put trade to work more effectively for economic development and poverty alleviation;
- (iii) To confirm the Central role that the rule based trading system plays for member Governments in managing their economic affairs cooperatively; and
- (iv) To organise the WTO on lines that more truly represent the needs of all members.

DOHA MINISTERIAL CONFERENCE, 2001

Ministerial Declaration adopted on November 14, 2001

In the light of the global economic slowdown, the Ministers expressed determination to maintain the process of reform and liberalization of trade policies, thus ensuring that the system plays its full part in promoting recovery, growth and development and reaffirmed the principles and objectives set out in the Marrakesh Agreement Establishing the World Trade Organization, and pledged to reject the use of protectionism.

Recognising that the majority of WTO members are developing countries, Ministers urged to place their needs and interests at the heart of the Work Programme adopted in Declaration and continue to make positive efforts designed to ensure that developing countries, and especially the least-developed among them, secure a share in the growth of world trade commensurate with the needs of their economic development.

Recognizing the particular vulnerability of the least-developed countries and the special structural difficulties they face in the global economy, Ministers expressed their commitment to addressing the marginalization of least-developed countries in international trade and to improving their effective participation in the multilateral trading system.

Ministers stressed their commitment to the WTO as the unique forum for global trade rule-making and liberalization, while also recognizing that regional trade agreements can play an important role in promoting the liberalization and expansion of trade and in fostering development.

Ministers welcomed the WTO's continued cooperation with UNEP and other inter-governmental environmental organizations and encouraged efforts to promote cooperation between the WTO and relevant international environmental and developmental organizations.

Recognizing the challenges posed by an expanding WTO membership, Ministers confirmed their collective responsibility to ensure internal transparency and effective participation of all members. While emphasizing the intergovernmental character of the organization, Ministers committed themselves to making the WTO's operations

more transparent, through more effective and prompt dissemination of information, and to improve dialogue with the public.

WORK PROGRAMME

Implementation-related issues and concerns

Ministers attached utmost importance to the implementation-related issues and concerns raised by members and expressed determination to find appropriate solutions to them. In this connection, and having regard to the General Council Decisions of 3 May and 15 December 2000, Ministers further adopted the Decision on Implementation-Related Issues and Concerns in document WT/MIN(01)/17 to address a number of implementation problems faced by members. In this regard, Ministers agreed to proceed as follows:

- (a) where specific negotiating is mandated, the relevant implementation issues shall be addressed under that mandate;
- (b) the other outstanding implementation issues shall be addressed as a matter of priority by the relevant WTO bodies, which shall report to the Trade Negotiations Committee by the end of 2002 for appropriate action.

Agriculture

Recognizing the work undertaken in the negotiations initiated in early 2000 under Article 20 of the Agreement on Agriculture, including the large number of negotiating proposals submitted on behalf of a total of 121 members, Ministers recalled the long-term objective referred to in the Agreement to establish a fair and market-oriented trading system through a programme of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct and prevent restrictions and distortions in world agricultural markets.

Building on the work carried out and without prejudging the outcome of the negotiations Ministers committed themselves to comprehensive negotiations aimed at: substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support.

Ministers agreed that special and differential treatment for developing countries shall be an integral part of all elements of the negotiations and shall be embodied in the schedules of concessions and commitments and as appropriate in the rules and disciplines to be negotiated, so as to be operationally effective and to enable developing countries to effectively take account of their development needs, including food security and rural development.

Taking note of the non-trade concerns reflected in the negotiating proposals submitted by Members, Ministers confirmed that non-trade concerns will be taken into account in the negotiations as provided for in the Agreement on Agriculture.

Market access for non-agricultural products

Ministers agreed to negotiations to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as

well as non-tariff barriers, in particular on products of export interest to developing countries. The negotiations to take fully into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in reduction commitments, in accordance with the relevant provisions of Article XXVIII bis of GATT 1994 and the provisions of this declaration. To this end, the modalities to be agreed include appropriate studies and capacity-building measures to assist least-developed countries to participate effectively in the negotiations.

Relationship between trade and investment

Recognizing the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment for the expansion of trade, and the need for enhanced technical assistance and capacity-building in this area, Ministers agreed that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations.

Interaction between trade and competition policy

Recognizing the case for a multilateral framework to enhance the contribution of competition policy to international trade and development, and the need for enhanced technical assistance and capacity-building in this area, Ministers agreed that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations.

Transparency in government procurement

Recognizing the case for a multilateral agreement on transparency in government procurement and the need for enhanced technical assistance and capacity building in this area, Ministers agreed that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations.

Trade facilitation

Recognizing the case for further expediting the movement, release and clearance of goods, including goods in transit, and the need for enhanced technical assistance and capacity building in this area, Ministers agreed that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations.

WTO rules

In the light of experience and of the increasing application of these instruments by members, Ministers agreed to negotiations aimed at clarifying and improving disciplines under the Agreements on Implementation of Article VI of the GATT 1994 and on Subsidies and Countervailing Measures, while preserving the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives, and taking into account the needs of developing and least-developed

participants. In the initial phase of the negotiations, participants will indicate the provisions, including disciplines on trade distorting practices that they seek to clarify and improve in the subsequent phase.

Trade and environment

With a view to enhancing the mutual supportiveness of trade and environment, Ministers agreed to negotiations, without prejudging their outcome, on:

- (i) the relationship between existing WTO rules and specific trade obligations set out in multilateral environmental agreements (MEAs). The negotiations shall be limited in scope to the applicability of such existing WTO rules as among parties to the MEA in question. The negotiations shall not prejudice the WTO rights of any Member that is not a party to the MEA in question;
- (ii) procedures for regular information exchange between MEA Secretariats and the relevant WTO committees, and the criteria for granting of observer status;
- (iii) the reduction or, as appropriate, elimination of tariff and non-tariff barriers to environmental goods and services.

Ministers instructed the Committee on Trade and Environment, in pursuing work on all items on its agenda within its current terms of reference, to give particular attention to:

- (i) the effect of environmental measures on market access, especially in relation to developing countries, in particular the least-developed among them, and those situations in which the elimination or reduction of trade restrictions and distortions would benefit trade, the environment and development;
- (ii) the relevant provisions of the Agreement on Trade-Related Aspects of Intellectual Property Rights; and
- (iii) labelling requirements for environmental purposes.

Work on these issues should include the identification of any need to clarify relevant WTO rules.

Small Economies

Ministers agreed to a work programme, under the auspices of the General Council, to examine issues relating to trade of small economies. The objective of this work includes to frame responses to the trade-related issues identified for the fuller integration of small, vulnerable economies into the multilateral trading system, and not to create a sub-category of WTO Members.

Trade, debt and finance and Trade and transfer of technology

Ministers agreed to an examination, in a Working Group under the auspices of the General Council, of the relationship between trade, debt and finance & trade and transfer of technology, and of any possible recommendations on steps that might be taken within the mandate of the WTO.

Technical cooperation and capacity building

Confirming that technical cooperation and capacity building are core elements of

the development dimension of the multilateral trading system, Ministers welcomed and endorsed the New Strategy for WTO Technical cooperation for Capacity Building, Growth and Integration. Ministers instructed the Secretariat, in coordination with other relevant agencies, to support domestic efforts for mainstreaming trade into national plans for economic development and strategies for poverty reduction.

Least-developed countries

Acknowledging the seriousness of the concerns expressed by the least-developed countries (LDCs) in the Zanzibar Declaration adopted in July 2001, Ministers recognized that the integration of the LDCs into the multilateral trading system requires meaningful market access, support for diversification of their production and export base, and trade-related technical assistance and capacity building. Members committed themselves to the objective of duty-free, quota-free market access for products originating from LDCs and to consider additional measures for progressive improvements in market access for LDCs.

Special and differential treatment

Reaffirming that the provisions for special and differential treatment are an integral part of the WTO Agreements, Ministers noted the concerns expressed regarding their operation in addressing specific constraints faced by developing countries, particularly least-developed countries and agreed to review all special and differential treatment provisions with a view to strengthening them and making them more precise, effective and operational.

Supervision of Negotiations

Ministers agreed that overall conduct of the negotiations shall be supervised by a Trade Negotiations Committee under the authority of the General Council. The Trade Negotiations Committee shall hold its first meeting not later than 31 January, 2002. It shall establish appropriate negotiating mechanisms as required and supervise the progress of the negotiations.

With the exception of the improvements and clarifications of the Dispute Settlement Understanding, the conduct, conclusion and entry into force of the outcome of the negotiations shall be treated as part of a single undertaking. However, agreements reached at an early stage may be implemented on a provisional or a definitive basis. Early agreements shall be taken into account in assessing the overall balance of the negotiations. The negotiations shall be open to—

- (i) all members of the WTO; and
- (ii) States and separate customs territories currently in the process of accession and those that inform members, at a regular meeting of the General Council, of their intention to negotiate the terms of their membership and for whom an accession working party is established. Decisions on the outcomes of the negotiations shall be taken only by WTO members.

The negotiations shall be conducted in a transparent manner among participants, in order to facilitate the effective participation of all. They shall be conducted with a

view to ensuring benefits to all participants and to achieving an overall balance in the outcome of the negotiations.

The negotiations and the other aspects of the Work Programme shall take fully into account the principle of special and differential treatment for developing and least-developed countries embodied in Part IV of the GATT 1994; the Decision of 28 November, 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries; the Uruguay Round Decision on Measures in Favour of Least-Developed Countries; and all other relevant WTO provisions.

The Committee on Trade and Development and the Committee on Trade and Environment shall, within their respective mandates, act as a forum to identify and debate developmental and environmental aspects of the negotiations, in order to help achieve the objective of having sustainable development appropriately reflected.

CANCUN MINISTERIAL CONFERENCE, 2003

(The following text was distributed at the Cancún Ministerial Conference on 13 September, 2003).

Reaffirming declarations made and the decisions taken at Doha; the progress made towards carrying out the Work Programme agreed at Doha and recommitting themselves to completing it fully, Ministers renewed their determination to conclude the negotiations launched at Doha successfully by the agreed date of 1 January, 2005. In pursuance of these objectives, Ministers welcomed the decision on implementation of Doha Declaration on the TRIPS Agreement and Public Health.

Agriculture negotiations

Reaffirming their commitment to the mandate on agriculture as set out in Doha Ministerial Declaration, and taking note of the progress made by the Special Session of the Committee on Agriculture in this regard, Ministers agreed to intensify work to translate the Doha objectives into reform modalities and adopted the framework concerning the further commitments and related disciplines on key outstanding issues on market access, export competition and domestic support as the basis for concluding the work in these areas.

NAMA negotiations

Reaffirming the commitment to the mandate for negotiations on market access for non-agricultural products as set out in Doha Ministerial Declaration and taking note of the progress made by the Negotiating Group on Market Access in this regard, Ministers agreed to intensify work to translate Doha objectives into modalities for these negotiations and adopted the framework for modalities for negotiations on non-agricultural products.

Services negotiations

Committing themselves to intensifying efforts to bring the negotiations on specific commitments to conclusion, Ministers stressed the importance of full engagement by all participants, *inter alia* through the continuous exchange of requests and offers with a view to concluding the negotiations by the agreed date. Ministers also committed to intensifying their efforts to conclude the negotiations on rule-making under GATS Articles VI:4, X, XIII, and XV in accordance with their respective

mandates and deadlines, including the deadline of 15 March, 2004 for emergency safeguard measures. Ministers reaffirmed that the negotiations shall aim to achieve progressively higher levels of liberalization with no *a priori* exclusion of any service sector or mode of supply and shall give special attention to sectors and modes of supply of export interest to developing countries. Ministers also noted the interest of developing countries, as well as other Members, in Mode 4.

Rules negotiations

Ministers instructed the Negotiating Group on Rules to accelerate its work on anti-dumping and subsidies & countervailing measures, including fisheries subsidies, with a view to shifting its emphasis from identifying issues to seeking solutions.

S&D treatment

Reaffirming that provisions for special and differential treatment are an integral part of WTO Agreements and recalling their decision in Doha to review special and differential treatment provisions with a view to strengthening and making them more precise, effective and operational, Ministers noted the progress made towards meeting these objectives, and instructed the General Council to continue to monitor closely work on the proposals referred to negotiating groups and other WTO bodies, and direct these bodies to report to the General Council.

Ministers also instructed the Committee on Trade and Development in Special Session to pursue expeditiously, within the parameters of the Doha mandate, the work on remaining agreement-specific proposals and other outstanding issues and report with recommendations, as appropriate, to the General Council.

Investment

Ministers reiterated that the special development, trade and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable Members to undertake obligations and commitments commensurate with their individual needs and circumstances. Consideration should be given to the relationship of the negotiations to the Single Undertaking.

Competition

In accordance with relevant provisions of Doha Ministerial Declaration, Ministers committed themselves to continue to provide strengthened and adequately resourced technical assistance to developing and least-developed countries to respond to their needs for enhanced support in this area.

Small Economies

Ministers reaffirmed their commitment to the Work Programme on Small Economies and urged Members to adopt specific measures to facilitate fuller integration of small, vulnerable economies into the multilateral trading system.

TRIPS non-violation

Taking note of the work done by the Council for Trade-Related Aspects of

Intellectual Property Rights pursuant to Doha Decision on Implementation-Related Issues and Concerns, Ministers directed the Council to continue its examination of the scope and modalities for complaints of the types provided for under subparagraphs 1(b) and 1(c) of Article XXIII of GATT 1994 and make recommendations.

Least Developed Countries

Taking note that the issues of interest to LDCs are being addressed in all areas of negotiations, Minister decided to continue to expeditiously pursue the objective of duty-free and quota-free market access for products originating from LDCs. Ministers urged Members to adopt and implement rules of origin so as to facilitate exports from LDCs and appreciated the improved market access measures adopted by several Members.

Sectoral Initiative on Cotton

Ministers recognised the importance of cotton for the development of a number of developing countries and the need for urgent action to address trade distortions in these markets. Accordingly, they instruct the Chairman of the Trade Negotiations Committee to consult the Chairpersons of the Negotiating Groups on Agriculture, Non-Agricultural Market Access and Rules to address the impact of the distortions that exist in the trade of cotton, man-made fibres, textiles and clothing to ensure comprehensive consideration of the entirety of the sector.

Commodity Issues

Taking into account the dependence of many developing countries on a few commodities and the problems created by long-term declines and sharp fluctuations in the prices of these commodities, Ministers instructed the Committee on Trade and Development, within its mandate, to continue with its work on this issue in cooperation with other relevant international organizations and report on progress to the General Council before the next Session.

HONG KONG MINISTERIAL CONFERENCE, 2005

Ministerial Declaration adopted on December 18, 2005

The Ministers renewed their resolve to complete the Doha Work Programme fully and to conclude the negotiations launched at Doha successfully in 2006.

Agricultural Negotiations

The Ministers reaffirmed their commitment to the mandate on agriculture as set out in Doha Ministerial Declaration and to the framework adopted by the General Council.

On domestic support, Ministers noted that there will be three bands for reductions in Final Bound Total AMS and in the overall cut in trade-distorting domestic support, with higher linear cuts in higher bands. In both cases, the Member with the highest level of permitted support will be in the top band, the two Members with the second and third highest levels of support will be in the middle band and all other Members, including all developing country Members, will be in the bottom band. In addition, developed country Members in the lower bands with high relative levels of Final Bound Total AMS will make an additional effort in AMS reduction.

Ministers also noted that there has been some convergence concerning the reductions in Final Bound Total AMS, the overall cut in trade-distorting domestic support and in both product-specific and non product-specific de minimis limits. Disciplines will be developed to achieve effective cuts in trade-distorting domestic support consistent with the Framework. The overall reduction in trade-distorting domestic support will still need to be made even if the sum of reductions in Final Bound Total AMS, de minimis and Blue Box payments would otherwise be less than that of overall reduction. Developing country Members with no AMS commitments will be exempt from reductions in de minimis and the overall cut in trade-distorting domestic support. Green Box criteria will be reviewed to ensure that programmes of developing country Members that cause not more than minimal trade-distortion are effectively covered.

Ministers agreed to ensure the parallel elimination of all forms of export subsidies and disciplines on all export measures with equivalent effect to be completed by the end of 2013. This will be achieved in a progressive and parallel manner, to be specified in the modalities, so that a substantial part is realized by the end of first half of the implementation period. While noting that the emerging convergence on some elements of disciplines with respect to export credits, export credit guarantees or insurance programmes with repayment periods of 180 days and below, the Ministers agreed that such programmes should be self-financing, reflecting market consistency, and that the period should be of a sufficiently short duration so as not to effectively circumvent real commercially-oriented discipline. As a means of ensuring that trade-distorting practices of STEs are eliminated, disciplines relating to exporting STEs will extend to the future use of monopoly powers so that such powers cannot be exercised in any way that would circumvent the direct disciplines on STEs on export subsidies, government financing and the underwriting of losses.

On food aid, Ministers reconfirmed their commitment to maintain an adequate level and to take into account the interests of food aid recipient countries. To this end, a "safe box" for *bona fide* food aid will be provided to ensure that there is no unintended impediment to dealing with emergency situations. Beyond that, Ministers will ensure elimination of commercial displacement. To this end, Ministers agreed to effective disciplines on in-kind food aid, monetization and re-exports so that there can be no loop-hole for continuing export subsidization. The disciplines on export credits, export credit guarantees or insurance programmes, exporting state trading enterprises and food aid will be completed by 30 April, 2006 as part of the modalities, including appropriate provision in favour of least-developed and net food-importing developing countries as provided for in the Marrakesh Decision.

The date above for the elimination of all forms of export subsidies, together with the agreed progressivity and parallelism, will be confirmed only upon the completion of the modalities. Developing country Members will continue to benefit from the provisions of Agreement on Agriculture for five years after the end-date for elimination of all forms of export subsidies.

On market access, Ministers adopted four bands for structuring tariff cuts, recognizing the need to agree on the relevant thresholds - including those applicable for developing country Members. Recognizing the need to agree on treatment of sensitive products and taking into account all the elements involved, Ministers also noted that there have been some recent movements on the designation and

treatment of Special Products and elements of Special Safeguard Mechanism. Developing country Members will have the flexibility to self-designate an appropriate number of tariff lines as Special Products guided by indicators based on the criteria of food security, livelihood security and rural development. Developing country Members will also have the right to have recourse to a Special Safeguard Mechanism based on import quantity and price triggers, with precise arrangements to be further defined. Special Products and Special Safeguard Mechanism shall be an integral part of the modalities and the outcome of negotiations in agriculture.

Reaffirming that nothing agreed compromises the agreement already reflected in the Framework on other issues including tropical products and products of particular importance to the diversification of production from the growing of illicit narcotic crops, long-standing preferences and preference erosion, the Ministers agreed to intensify work on all outstanding issues to fulfil Doha objectives and in particular, resolved to establish modalities no later than 30 April, 2006 and to submit comprehensive draft Schedules based on these modalities no later than 31 July, 2006.

Cotton

The Ministers reaffirmed their commitment, to ensure having an explicit decision on cotton within the agriculture negotiations and through the Sub-Committee on Cotton ambitiously, expeditiously and specifically, as follows:

- All forms of export subsidies for cotton will be eliminated by developed countries in 2006.
- On market access, developed countries will give duty and quota free access for cotton exports from least-developed countries (LDCs) from the commencement of the implementation period.
- The Members committed themselves to give priority in the negotiations to ensure that trade distorting domestic subsidies for cotton production be reduced more ambitiously than under whatever general formula is agreed and that it should be implemented over a shorter period of time than generally applicable.

NAMA negotiations

The Ministers reaffirmed their commitment to the mandate for negotiations on market access for non-agricultural products and all the elements of the NAMA framework. The Ministers adopted a Swiss Formula with coefficients at levels which shall *inter alia*:

- Reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs and tariff escalation, in particular on products of export interest to developing countries; and
- Take fully into account the special needs and interests of developing countries, including through less than full reciprocity in reduction commitments.

Ministers agreeing to intensify work on all outstanding issues to fulfil Doha objectives resolved in particular to establish modalities no later than 30 April, 2006 and to submit comprehensive draft Schedules based on these modalities no later than 31 July, 2006.

Services negotiations

The negotiations on trade in services shall proceed to their conclusion with a view to promoting the economic growth of all trading partners and the development of developing and least-developed countries, and with due respect for the right of Members to regulate.

The Ministers urged all Members to participate actively in these negotiations towards achieving a progressively higher level of liberalization of trade in services, with appropriate flexibility for individual developing countries as provided for in Article XIX of the GATS. Negotiations to have regard to the size of economies of individual Members, both overall and in individual sectors. Ministers recognized the particular economic situation of LDCs, including the difficulties they face, and acknowledged that they are not expected to undertake new commitments.

TRIPS negotiations

Taking note of the report of the Chairman of the Special Session of the Council for TRIPS setting out the progress in the negotiations on the establishment of a multilateral system of notification and registration of geographical indications for wines and spirits, Ministers agreed to intensify these negotiations in order to complete them within the overall time-frame for the conclusion of negotiations that were foreseen in Doha Ministerial Declaration.

Integrated Framework (IF)

The Ministers agreed that the Task Force, in line with its Mandate and based on the three elements agreed to, shall provide recommendations on how the implementation of the IF can be improved, *inter alia*, by considering ways to:

- provide increased, predictable, and additional funding on a multi-year basis;
- strengthen the IF in-country, including through mainstreaming trade into national development plans and poverty reduction strategies; more effective follow-up to diagnostic trade integration studies and implementation of action metrics; and achieving greater and more effective coordination amongst donors and IF stakeholders, including beneficiaries;
- improve the IF decision-making and management structure to ensure an effective and timely delivery of increased financial resources and programmes.

The Ministerial declaration also includes progress on negotiations and further actions in the areas of environment, trade facilitation, Dispute Settlement Understanding, Special & Differential treatment, matters relating to implementation, TRIPs & Public Health, small economies, trade, debt and finance, trade & transfer of technology, E-Commerce and Least Developed Countries.

GENEVA MINISTERIAL CONFERENCE, 2009

The Seventh Session of the WTO Ministerial Conference in Geneva, Switzerland, took place from 30 November to 2 December 2009. The general theme for discussion was “The WTO, the Multilateral Trading System and the Current Global Economic Environment”.

The Seventh Ministerial Conference of the WTO has brought together nearly 3,000 delegates representing all 153 Members as well as 56 Observers.

The major provisions of Declarations adopted at the Ministerial Conference are given below:

There was strong convergence on the importance of trade and the Doha Round to economic recovery and poverty alleviation in developing countries and priority is being given to Agriculture and NAMA, it is important to advance on other areas on the agenda, including Services, Rules and Trade Facilitation.

LDC-specific issues were underlined as needing particular attention, including Duty-Free Quota-Free market access, cotton, and the LDC Waiver for Services. The particular needs of Small and Vulnerable Economies were also emphasized. Many stressed the need to adhere to the 2002 guidelines for LDC accession. There was broad support for the suggestion that there should be a sharing of experiences, particularly those of the recently acceded Members. There was, though, some divergence as to how to advance accessions, whether through closer collective action or through the usual practice of giving priority to bilateral channels.

Capacity-building was seen as vital to addressing supply-side constraints. The importance of keeping up the momentum of Aid for Trade, including the Enhanced Integrated Framework, was stressed. There was wide agreement on the need to continue actively mobilizing resources and to keep up monitoring implementation of commitments.

There was broad agreement that the growing number of bilateral and regional trade agreements is an issue for the multilateral trading system. However, the idea of extending to all Members benefits offered in a regional context was questioned by some.

There were suggestions that while the WTO RTA transparency mechanism had worked quite well, there is still room for improvement, through making the mechanism permanent, highlighting better the common elements in different RTAs and introducing an annual review.

Ministers had a wide-ranging discussion on enhancing the institutional effectiveness of the WTO. Its monitoring and analytical work was widely seen to have been of particular value in helping to stave off protectionist responses to the crisis. There was substantial convergence on the need to improve notifications as well as data collection, analysis and dissemination.

High value continues to be placed by members on transparency and inclusiveness in the WTO. Improving the institution's effectiveness should not compromise this principle.

The value of the Dispute Settlement System was underlined by many participants, with some urging that it be made more responsive to the needs and circumstances of poorer and smaller Members.

Numerous comments were made on other current and future issues facing the WTO. Climate change was raised by many. The contribution the WTO can make

through removing barriers to trade in environmental goods and services was widely endorsed. There were also warnings against "green protectionism". Food security and energy security were also highlighted. Other items suggested for consideration included government procurement, competition and investment, though reservations were also expressed.

There was broad agreement that the WTO must remain credible in the face of emerging challenges. There were calls for deepening the WTO's relationship with other relevant international organizations, while respecting the WTO's mandates.

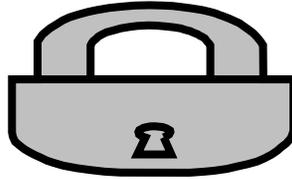
It was widely acknowledged that the importance of the WTO extends beyond the Round. It was also noted that the Round - a stimulus package with limited fiscal cost - is vital in order to ensure that the WTO remains relevant.

LESSON ROUND UP



- The Ministerial Conference – the highest decision making body of WTO has to meet at least every two years.
- The Ministers met in Singapore from 9 to 13 December, 1996 for the first regular biennial meeting of the WTO, to further strengthen the WTO as a forum for negotiation, the continuing liberalization of trade within a rule-based system, and the multilateral review and assessment of trade policies,
- At Geneva Ministerial Conference, 1998, Ministers agreed to work together in the WTO to improve the coherence of international economic policy-making with a view to maximizing the contribution that an open, rule-based trading system can foster stable growth for economies at all levels of development.
- The Third WTO Ministerial Conference held in Seattle, Washington, USA between November 30 and December 3, 1999, was suspended without adopting any declaration.
- In the light of the global economic slowdown, the Ministers, in Doha Ministerial Conference expressed determination to maintain the process of reform and liberalization of trade policies, and pledged to reject the use of protectionism.
- The Ministerial declaration in Hong Kong Conference, 2005 includes progress on negotiations and further actions in the areas of environment, trade facilitation, Dispute Settlement Understanding, Special & Differential treatment, matters relating to implementation, TRIPs & Public Health, small economies, trade, debt and finance, trade & transfer of technology, E-Commerce and Least Developed Countries
- The Seventh Session of the WTO Ministerial Conference in Geneva, Switzerland, took place from 30 November to 2 December 2009. The general theme for discussion was "The WTO, the Multilateral Trading System and the Current Global Economic Environment".

SELF TEST QUESTIONS

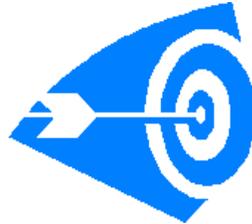


1. Explain the importance of Ministerial Conferences under the WTO system.
2. Discuss the salient features of Singapore Ministerial declaration on Information Technology Products.
3. Discuss the progress on Negotiations on Agriculture under Hongkong Ministerial Conference.
4. Doha declaration on TRIPs was in favour of the developing countries. Elaborate.
5. Explain the reasons for failure of Seattle Conference in 1999.
6. Explain the major issues before the Ministerial Conferences.

STUDY XIV

ANTI-DUMPING, SUBSIDIES AND COUNTERVAILING DUTIES (ANTI-DUMPING DUTIES)

LEARNING OBJECTIVE



The objective of this study lesson is to enable the students to understand:

- Agreement on Implementation of Article VI (Anti-dumping)
- Article VI of GATT and the Anti-Dumping Agreement
- Development of Anti-Dumping
- Anti-Dumping and Indian Laws
- Determination of Dumping
- Investigation Process
- Significance of Anti-Dumping Duty

AGREEMENT ON IMPLEMENTATION OF ARTICLE VI (ANTI-DUMPING)

Article VI of the GATT provides for the right of contracting parties to apply anti-dumping measures, i.e. measures against imports of a product at an export price below its “normal value” (usually the price of the product in the domestic market of the exporting country) if such dumped imports cause injury to a domestic industry in the territory of the importing contracting party. More detailed rules governing the application of such measures are currently provided in an Anti-dumping Agreement concluded at the end of the Tokyo Round. Negotiations in the Uruguay Round have resulted in a revision of this Agreement which addresses many areas in which the current Agreement lacks precision and detail.

In particular, the revised Agreement provides for greater clarity and more detailed rules in relation to the method of determining that a product is dumped, the criteria to be taken into account in a determination that dumped imports cause injury to a domestic industry, the procedures to be followed in initiating and conducting anti-dumping investigations, and the implementation and duration of anti-dumping measures. In addition, the new agreement clarifies the role of dispute settlement panels in disputes relating to anti-dumping actions taken by domestic authorities.

On the methodology for determining that a product is exported at a dumped price, the new Agreement adds relatively specific provisions on such issues as criteria for allocating costs when the export price is compared with a “constructed” normal value and rules to ensure that a fair comparison is made between the export

price and the normal value of a product so as not to arbitrarily create or inflate margins of dumping.

The agreement strengthens the requirement for the importing country to establish a clear causal relationship between dumped imports and injury to the domestic industry. The examination of the dumped imports on the industry concerned must include an evaluation of all relevant economic factors bearing on the state of the industry concerned. The agreement confirms the existing interpretation of the term “domestic industry”. Subject to a few exceptions, “domestic industry” refers to the domestic producers as a whole of the like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products.

Clear-cut procedures have been established on how anti-dumping cases are to be initiated and how such investigations are to be conducted. Conditions for ensuring that all interested parties are given an opportunity to present evidence are set out. Provisions on the application of provisional measures, the use of price undertakings in anti-dumping cases, and on the duration of anti-dumping measures have been strengthened. Thus, a significant improvement over the existing Agreement consists of the addition of a new provision under which anti-dumping measures shall expire five years after the date of imposition, unless a determination is made that, in the event of termination of the measures, dumping and injury would be likely to continue or recur.

A new provision requires the immediate termination of an anti-dumping investigation in cases where the authorities determine that the margin of dumping is *de minimis* (which is defined as less than 2 per cent, expressed as a percentage of the export price of the product) or that the volume of dumped imports is negligible (generally when the volume of dumped imports from an individual country accounts for less than 3 per cent of the imports of the product in question into the importing country).

The agreement calls for prompt and detailed notification of all preliminary or final anti-dumping actions to a Committee on Anti-dumping Practices. The agreement will afford parties the opportunity of consulting on any matter relating to the operation of the agreement or the furtherance of its objectives, and to request the establishment of panels to examine disputes.

What is dumping?

Dumping is, in general, a situation of international price discrimination, where the price of a product when sold in the importing country is less than the price of that product in the market of the exporting country. Thus, in the simplest of cases, one identifies dumping simply by comparing prices in two markets. However, the situation is rarely, if ever, that simple, and in most cases it is necessary to undertake a series of complex analytical steps in order to determine the appropriate price in the market of the exporting country (known as the “normal value”) and the appropriate price in the market of the importing country (known as the “export price”) so as to be able to undertake an appropriate comparison.



ARTICLE VI OF GATT AND THE ANTI-DUMPING AGREEMENT

The GATT 1994 sets forth a number of basic principles applicable in trade between Members of the WTO, including the “most favoured nation” principle. It also requires that imported products not be subject to internal taxes or other changes in excess of those imposed on domestic goods, and that imported goods in other respects be accorded treatment no less favourable than domestic goods under domestic laws and regulations, and establishes rules regarding quantitative restrictions, fees and formalities related to importation, and customs valuation. Members of the WTO also agreed to the establishment of schedules of bound tariff rates. Article VI of GATT 1994, on the other hand, explicitly authorizes the imposition of a specific anti-dumping duty on imports from a particular source, in excess of bound rates, in cases where dumping causes or threatens injury to a domestic industry, or materially retards the establishment of a domestic industry.

The Agreement on Implementation of Article VI of GATT 1994, commonly known as the Anti-Dumping Agreement, provides further elaboration on the basic principles set forth in Article VI itself, to govern the investigation, determination, and application, of anti-dumping duties.

What is anti dumping? What is its purpose in International Trade?

Dumping is said to occur when the goods are exported by a country to another country at a price lower than its normal value. This is an unfair trade practice which can have a distortive effect on international trade. Anti dumping is a measure to rectify the situation arising out of the dumping of goods and its trade distortive effect. Thus, the purpose of anti dumping duty is to rectify the trade distortive effect of dumping and re-establish fair trade. The use of anti dumping measure as an instrument of fair competition is permitted by the WTO. In fact, anti dumping is an instrument for ensuring fair trade and is not a measure of protection per se for the domestic industry. It provides relief to the domestic industry against the injury caused by dumping.



AGREEMENT ON IMPLEMENTATION OF ARTICLE VI OF THE GENERAL AGREEMENT ON TARIFFS AND TRADE 1994 (THE ANTI-DUMPING AGREEMENT)

The Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the “AD Agreement”) governs the application of anti-dumping measures by Members of the WTO. Anti-dumping measures are unilateral remedies which may be applied by a Member after an investigation and determination by that Member, in accordance with the provisions of the AD Agreement, that an imported product is “dumped” and that the dumped imports are causing material injury to a domestic industry producing the like product.

The AD Agreement sets forth certain substantive requirements that must be fulfilled in order to impose an anti-dumping measure, as well as detailed procedural requirements regarding the conduct of anti-dumping investigations and the imposition and maintenance in place of anti-dumping measures. A failure to respect either the substantive or procedural requirements can be taken to dispute settlement and may be the basis for invalidation of the measure. Unlike the Agreement on Subsidies and Countervailing Measures, the AD Agreement does not establish any disciplines on dumping itself, primarily because dumping is a pricing practice engaged in by business enterprises, and thus not within the direct reach of multilateral disciplines.

Substantive rules

Article 1 of the AD Agreement establishes the basic principle that a Member may not impose an anti-dumping measure unless it determines, pursuant to an investigation conducted in conformity with the provisions of the AD Agreement, that there are dumped imports, material injury to a domestic industry, and a causal link between the dumped imports and the injury.

Determination of dumping

Article 2 contains substantive rules for the determination of dumping. Dumping is calculated on the basis of a “fair comparison” between normal value (the price of the imported product in the “ordinary course of trade” in the country of origin or export) and export price (the price of the product in the country of import). Article 2 contains detailed provisions governing the calculation of normal value and export price, and elements of the fair comparison that must be made.

Determination of injury

Article 3 of the AD Agreement contains rules regarding the determination of material injury caused by dumped imports. Material injury is defined as material injury itself, threat of material injury, or material retardation of the establishment of a domestic industry. The basic requirement for determinations of injury, is that there be an objective examination, based on positive evidence of the volume and price effects of dumped imports and the consequent impact of dumped imports on the domestic industry. Article 3 contains specific rules regarding factors to be considered in making determinations of material injury, while specifying that no one or several of the factors which must be considered is determinative. Article 3.5 requires, in establishing the causal link between dumped imports and material injury, known factors other than dumped imports which may be causing injury must be examined, and that injury caused by these factors must not be attributed to dumped imports.

A significant new provision, Article 3.3, establishes the conditions in which a cumulative evaluation of the effects of dumped imports from more than one country may be undertaken. Under the rules, authorities must determine that the margin of dumping from each country is not *de minimis*, that the volume of imports from each country is not negligible, and that a cumulative assessment is appropriate in light of the conditions of competition among the imports and between the imports and the domestic like product.

Definition of industry

Article 4 of the AD Agreement sets forth a definition of the domestic industry to be considered for purposes of assessing injury and causation. The domestic industry is defined as producers of a “like product”, which term is defined in Article 2.6 as a product that is identical to, or in the absence of such a product, one that has characteristics closely resembling those of, the imported dumped product under consideration. Article 4 contains special rules for defining a “regional” domestic industry in exceptional circumstances where production and consumption in the importing country are geographically isolated, and for the evaluation of injury and assessment of duties in such cases. Article 4 also establishes that domestic producers may be excluded from consideration as part of the domestic industry if they are “related” (defined as a situation of legal or effective control) to exporters or importers of the dumped product.

Procedural requirements

A principal objective of the procedural requirements of the AD Agreement is to ensure transparency of proceedings, a full opportunity for parties to defend their interests, and adequate explanations by investigating authorities of their determinations. The extensive and detailed procedural requirements relating to investigations focus on the sufficiency of petitions (through minimum information and “standing” requirements) to ensure that meritless investigations are not initiated, on the establishment of time periods for the completion of investigations, and on the provision of access to information to all interested parties, along with reasonable opportunities to present their views and arguments. Additional procedural requirements relate to the offering, acceptance, and administration of price undertakings by exporters in lieu of the imposition of anti-dumping measures. The AD Agreement requires investigating authorities to give public notice of and explain their determinations at various stages of the investigative process in substantial detail. It also establishes rules for the timing of the imposition of anti-dumping duties, the duration of such duties, and obliges Members to periodically review the continuing need for anti-dumping duties and price undertakings. There are detailed provisions guiding the imposition and collection of duties under various duty assessment systems, intended to ensure that anti-dumping duties in excess of the margin of dumping are not collected, and that individual exporters are not subjected to anti-dumping duties in excess of their individual margin of dumping. Article 13 of the AD Agreement requires Members to provide for judicial review of final determinations in anti-dumping investigations and reviews. Other provisions establish that Members may, at their discretion, take anti-dumping actions on behalf of and at the request of a third country, and recognise that “special regard” must be given by developed country Members to the situation of developing country Members when considering the application of anti-dumping duties.

Initiation and conduct of investigations

Article 5 establishes the requirements for the initiation of investigations. The AD Agreement specifies that investigations should generally be initiated based on a written request submitted “by or on behalf of” a domestic industry. This “standing” requirement is supported by numeric limits for determining whether there is sufficient support by domestic producers to conclude that the request is made by or on behalf of the domestic industry, and thereby warrants initiation. The AD Agreement establishes requirements for evidence of dumping, injury, and causality, as well as

other information regarding the product, industry, importers, exporters, and other matters, in written applications for anti-dumping relief, and specifies that, in special circumstances when authorities initiate without a written application from a domestic industry, they shall proceed only if they have sufficient evidence of dumping, injury, and causality. In order to ensure that meritless investigations are not continued, potentially disrupting legitimate trade, Article 5.8 provides for immediate termination of investigations in the event the volume of imports is negligible or the margin of dumping is *de minimis*, and establishes numeric thresholds for these determinations. In order to minimize the trade disruptive effect of investigations, Article 5.10 specifies that investigations shall be completed within one year, and in no case more than 18 months, after initiation.

Article 6 sets forth detailed rules on the process of investigation, including the collection of evidence and the use of sampling techniques. It requires authorities to guarantee the confidentiality of sensitive information and verify the information on which determinations are based. In addition, to ensure the transparency of proceedings, authorities are required to disclose the information on which determinations are to be based to interested parties and provide them with adequate opportunity to comment, and establishes the rights of parties to participate in the investigation, including the right to meet with parties with adverse interests, for instance in a public hearing.

Imposition of provisional measures

Article 7 relates to the imposition of provisional measures. Article 7 includes the requirement that authorities make a preliminary affirmative determination of dumping, injury, and causality before applying provisional measures, and the requirement that no provisional measures may be applied sooner than 60 days after initiation of an investigation.

Price undertakings

Article 8 establishes the principle that undertakings to revise prices or cease exports at dumped prices may be entered into to settle an investigation, but only after a preliminary affirmative determination of dumping, injury, and causality has been made. It also establishes that undertakings are voluntary on the part of both exporters and investigating authorities. In addition, an exporter may request that the investigation be continued after an undertaking has been accepted, and if a final determination of no dumping, no injury, or no causality results, the undertaking shall automatically lapse.

Imposition and collection of duties

Article 9 establishes the general principle that imposition of anti-dumping duties is optional, even if all the requirements for imposition have been met, and establishes the desirability of application a “lesser duty” rule. Under a lesser duty rule, authorities impose duties at a level lower than the margin of dumping but adequate to remove injury. Article 9.3 establishes that anti-dumping duties may not exceed the dumping margin calculated during the investigation. In order to ensure that anti-dumping duties in excess of the margin of dumping are not collected, Article 9.3 requires procedures for determination of the actual amount of duty owed, or refund of excess duties paid, depending on the duty assessment system of a Member, normally within

12 months of a request, and in no case more than 18 months. Article 9.4 establishes rules for calculating the amount of duties to be imposed on exporters not individually examined during the investigation. Article 9.5 provides for expedited reviews to calculate individual margins of dumping for exporters or producers newly entering the market of the importing Member.

Article 10 establishes the general principle that both provisional and final anti-dumping duties may be applied only as of the date on which the determinations of dumping, injury, and causality have been made. However, recognizing that injury may have occurred during the period of investigation, or that exporters may have taken actions to avoid the imposition of an anti-dumping duty, Article 10 contains rules for the retroactive imposition of dumping duties in specified circumstances. If the imposition of anti-dumping duties is based on a finding of material injury, as opposed to threat of material injury or material retardation of the establishment of a domestic industry, anti-dumping duties may be collected as of the date provisional measures were imposed. If provisional duties were collected in an amount greater than the amount of the final duty, or if the imposition of duties is based on a finding of threat of material injury or material retardation, a refund of provisional duties is required. Article 10.6 provides for retroactive application of final duties to a date not more than 90 days prior to the application of provisional measures in certain exceptional circumstances involving a history of dumping, massive dumped imports, and potential undermining of the remedial effects of the final duty.

Duration, termination, and review of anti-dumping measures

Article 11 establishes rules for the duration of anti-dumping duties, and requirements for periodic review of the continuing need, if any, for the imposition of anti-dumping duties or price undertakings. These requirements respond to the concern raised by the practice of some countries of leaving anti-dumping duties in place indefinitely. The “sunset” requirement establishes that dumping duties shall normally terminate no later than five years after first being applied, unless a review investigation prior to that date establishes that expiry of the duty would be likely to lead to continuation or recurrence of dumping and injury. This five year “sunset” provision also applies to price undertakings. The AD Agreement requires authorities to review the need for the continued imposition of a duty upon request of an interested party.

Public notice

Article 12 sets forth detailed requirements for public notice by investigating authorities of the initiation of investigations, preliminary and final determinations, and undertakings. The public notice must disclose non-confidential information concerning the parties, the product, the margins of dumping, the facts revealed during the investigation, and the reasons for the determinations made by the authorities, including the reasons for accepting and rejecting relevant arguments or claims made by exporters or importers. These public notice requirements are intended to increase the transparency of determinations, with the hope that this will increase the extent to which determinations are based on fact and solid reasoning.

The committee and dispute settlement

Article 16 establishes the Committee on Anti-dumping Practices, and sets forth

requirements for Members to notify without delay all preliminary and final actions taken in anti-dumping investigations, and notify semi-annually all actions taken during the relevant reporting period.

Article 17 establishes that the Dispute Settlement Understanding is applicable to disputes under the AD Agreement. However, Article 17.6 establishes a **special** standard of review to be applied by panels in examining disputes in anti-dumping cases with regard both to matters of fact and questions of interpretation of the Agreement. This standard gives a degree of deference to the factual decisions and legal interpretations of national authorities, and is intended to prevent dispute settlement panels from making decisions based purely on their own views. A Ministerial Decision, which is not part of the AD Agreement, regarding this provision establishes that its operation will be reviewed after three years with a view to consideration whether it is capable of general application.

Final provisions

Article 18.3 establishes the effective date of the AD Agreement, providing that it is applicable to investigations and reviews of existing measures initiated pursuant to applications made on or after the entry into force of the AD Agreement. Article 18.4 requires Members to bring their laws into conformity with the AD Agreement by the date of entry into force of the AD Agreement. Under Article 18.5, Members are required to notify their anti-dumping laws and regulations to the Committee.

AD Agreement establishes procedures for “on-the-spot” investigations, which are generally undertaken in the territory of an exporting Member to verify information provided by foreign producers or exporters. Annex II to the AD Agreement sets forth provisions on the use of “best information available” in investigations, specifying the conditions under which investigating authorities may rely on information from a source other than the person concerned.

The Ministerial Decision on Anti-Circumvention, which is not part of the AD Agreement, noted that the negotiators had been unable to agree on a specific text dealing with the problem of anti-circumvention, recognized the desirability of applying uniform rules in this area as soon as possible, and referred the matter to the Committee for resolution. The Committee has established an Informal Group on Anti-Circumvention, which is open to participation by all Members, to carry out the task assigned by the Ministers.

ANTI-DUMPING AND INDIAN LAW

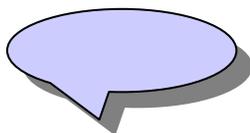
The General Agreement on Tariffs and Trade lays down the principles to be followed by the member countries for imposition of anti-dumping duties, countervailing duties and safeguard measures. Pursuant to the GATT, 1994, detailed guidelines have been prescribed under the specific agreements which have also been incorporated in the national legislation of the member countries of the WTO. Indian laws were amended with effect from 1.1.95 to bring them in line with the provisions of the respective GATT agreements.

Dumping is said to have taken place when an exporter sells a product to India at a price less than the price prevailing in its domestic market. However, the phenomenon of dumping is per se not condemnable as it is recognized that

producers sell their goods at different prices to different market. It is also not unusual for prices to vary from time to time in the light of supply and demand conditions. It is also recognized that price discrimination in the form of dumping is a common international commercial practice. It is also not uncommon that the export prices are lower than the domestic prices. Therefore, from the point of view of antidumping practices, there is nothing inherently illegal or immoral about the practice of dumping. However, where dumping causes or threatens to cause material injury to the domestic industry of India, the Designated Authority initiates necessary action for investigations and subsequent imposition of anti-dumping duties.

Sections 9A, 9B and 9C of the Customs Tariff Act, 1975 as amended in 1995 and the Customs Tariff (Identification, Assessment and Collection of Anti-dumping Duty on Dumped Articles and for Determination of Injury) Rules, 1995 framed thereunder form the legal basis for anti-dumping investigations and for the levy of anti-dumping duties. These laws are based on the Agreement on Anti-Dumping which is in pursuance of Article VI of GATT 1994.

Legal Framework



- *Based on Article VI of GATT 1994*
- *Customs Tariff Act, 1975 - Sec 9A, 9B (as amended in 1995)*
- *Anti-Dumping Rules [Customs Tariff (Identification, Assessment and Collection of Anti Dumping Duty on Dumped Articles and for Determination of Injury) Rules, 1995]*
- *Investigations and Recommendations by Designated Authority, Ministry of Commerce*
- *Imposition and Collection by Ministry of Finance*

Dumping

Dumping occurs when the export price of goods imported into India is less than the Normal Value of 'like articles' sold in the domestic market of the exporter. Imports at cheap or low prices do not per se indicate dumping. The price at which like articles are sold in the domestic market of the exporter is referred to as the "Normal Value" of those articles.

Normal Value

The normal value is the comparable price at which the goods under complaint are sold, in the ordinary course of trade, in the domestic market of the exporting country or territory. If the normal value cannot be determined by means of domestic sales, the Act provides for the following two alternative methods:

- (i) Comparable representative export price to an appropriate third country.

- (ii) Cost of production in the country of origin with reasonable addition for administrative, selling and general costs and for profits.

Export Price

The export price of goods imported into India is the price paid or payable for the goods by the first independent buyer.

DETERMINATION OF DUMPING

Constructed Export Price

If there is no export price or the export price is not reliable because of association or a compensatory arrangement between the exporter and the importer or a third party, the export price may be constructed on the basis of the price at which the imported articles are first resold to an independent buyer. If the articles are not resold as above or not resold in the same condition as imported, their export price may be determined on a reasonable basis.

Margin of Dumping

Margin of dumping refers to the difference between the Normal Value of the like article and the Export Price of the product under consideration. Margin of dumping is normally established on the basis of a comparison of weighted average Normal Value with a weighted average of prices of comparable export transactions; or comparison of normal values and export prices on a transaction-to-transaction basis.

A Normal Value established on a weighted average basis may be compared to prices of individual export transactions if the Designated Authority finds a pattern of export prices that differ significantly among different purchasers, regions, time period, etc. It is significant to note that the alternative method of comparing the normal values and export prices is a major change introduced after the Uruguay Round. The margin of dumping is generally expressed as a percentage of the export price.

Factors Affecting Comparison of Normal Value and Export Price

The export price and the normal value of the goods must be compared at the same level of trade, normally at the ex-factory level, for sales made as near as possible in time. Due allowance is made for differences that affect price comparability of a domestic sale and an export sale. These factors, *inter alia*, include physical characteristics, levels of trade, quantities, taxation and conditions and terms of sale.

It must be noted that the above factors are only indicative and any factor which can be demonstrated to affect the price comparability, is considered by the Authority.

Like Articles

Anti-dumping action can be taken only when there is an Indian industry which produces "like articles" when compared to the allegedly dumped imported goods. The article produced in India must either be identical to the dumped goods in all respects or in the absence of such an article, another article that has characteristics closely resembling those goods.

Injuries to the Domestic Industry

The Indian industry must be able to show that dumped imports are causing or are threatening to cause material injury to the Indian 'domestic industry'. Material retardation to the establishment of an industry is also regarded as injury. The material injury or threat thereof cannot be based on mere allegation, statement or conjecture. Sufficient evidence must be provided to support the contention of material injury. Injury analysis can broadly be divided in two major areas:

The Volume Effect

The Authority examines the volume of the dumped imports, including the extent to which there has been or is likely to be a significant increase in the volume of dumped imports, either in absolute terms or in relation to production or consumption in India, and its affect on the domestic industry.

The Price Effect

The effect of the dumped imports on prices in the Indian market for like articles, including the existence of price undercutting, or the extent to which the dumped imports are causing price depression or preventing price increases for the goods which otherwise would have occurred. The consequent economic and financial impact of the dumped imports on the concerned Indian industry can be demonstrated, *inter alia*, by decline in output, loss of sales, loss of market share, reduced profits, decline in productivity, decline in capacity utilization, reduced return on investments, price effects, adverse effects on cash flow, inventories, employment, wages, growth, investments, ability to raise capital, etc. Injury analysis is a detailed and intricate examination of all the relevant factors. It is not necessary that all the factors considered relevant should individually show injury to the domestic industry.

Causal Link

A 'causal link' must exist between the material injury being suffered by the Indian industry and the dumped imports. In addition, other injury causes have to be investigated so that they are not attributed to dumping. Some of these are volume and prices of imports not sold at dumped prices, contraction in demand or changes in the pattern of consumption, export performance, productivity of the domestic industry etc.

DUMPING INVESTIGATION

A dumping investigation can normally be initiated only upon receipt of a written application by or on behalf of the "Domestic Industry". In order to constitute a valid application, the following two conditions have to be satisfied:

The domestic producers expressly supporting the application must account for not less than 25% of the total production of the like article by the domestic industry in India; and

The domestic producers expressly supporting the application must account for more than 50% of the total production of the like article by those expressly supporting and those opposing the application.

Domestic Industry

Domestic industry means the Indian producers of like articles as a whole or those

producers whose collective output constitutes a major proportion of total Indian production. Producers who are related to the exporters or importers or are themselves importers of the allegedly dumped goods shall be deemed not to form part of the domestic industry.

De Minimis Margins

Any exporter whose margin of dumping is less than 2% of the export price shall be excluded from the purview of anti-dumping duties even if the existence of dumping, injury as well as the causal link is established. Further, investigations against any country are required to be terminated if the volume of the dumped imports from that particular source are found to be below 3% of the total imports, provided the cumulative imports from all those countries who individually account for less than 3%, are not more than 7%.

Price Undertakings

The Designated Authority may suspend or terminate investigation if the exporter concerned furnished an undertaking to revise his price to remove the dumping or the injurious effect of dumping as the case may be. No undertaking can however be accepted before preliminary determination is made. No anti-dumping duties are recommended on such exporters from whom price undertaking has been accepted. No price undertaking may, however, be accepted in case it is found that acceptance of such undertaking is impracticable or is unacceptable for any reason.

Application Procedure

Specific authorization of the party providing the information is required, if the Designated Authority is satisfied about its confidentiality. The designated authority in India is Director General of Anti-Dumping – DGAD – in the Ministry of Commerce. Interested parties supplying information on a confidential basis are required to furnish non-confidential summaries thereof or a statement of reasons as to why such summarization is not possible. If the Designated Authority is not satisfied that the confidentiality is warranted or the provider of information is not willing to disclose it in a generalized form, then such information may be disregarded.

An application received by the Designated Authority is dealt with in following manner:

Preliminary Screening

The application is scrutinized to ensure that it is adequately documented and provides sufficient evidence for initiation. If the evidence is not adequate, then a deficiency letter is issued normally within 20 days of the receipt of the application.

Initiation

When the Designated Authority is satisfied that there is sufficient evidence in the application with regard to dumping, material injury and causal link, a Public Notice is issued initiating an investigation to determine the existence and effect of the alleged dumping. The Designated Authority notifies the diplomatic representative of the Government of the exporting country before proceeding to initiate the investigation. The initiation notice will be issued normally within 45 days of the date of receipt of a properly documented application.

Access to Information

The Authority provides access to the non-confidential evidence presented to it by various interested parties in the form of a public file, which is available for inspection after receipt of the responses.

Preliminary Findings

The Designated Authority will proceed expeditiously with the conduct of the investigation and shall, in appropriate cases, make a preliminary finding containing the detailed information on the main reasons behind it.

INVESTIGATION PROCESS

The preliminary finding will normally be made within 150 days of the date of initiation.

Provisional Duty

A provisional duty not exceeding the margin of dumping may be imposed by the Central Government on the basis of the preliminary finding recorded by the Designated Authority. The provisional duty can be imposed only after the expiry of 60 days from the date of initiation of investigation. The provisional duty will remain in force only for a period not exceeding six months, extendable to nine months under certain circumstances.

Oral Evidence

Interested parties who participate in the investigations can request the Designated Authority for an opportunity to present the relevant information orally. However, such oral information shall be taken into consideration only when it is subsequently reproduced in writing. The Authority may grant oral hearing anytime during the course of the investigations.

Final Determination

The final determination is normally made within 150 days of the date of Preliminary determination.

Disclosure of Information

The Designated Authority will inform all interested parties of the essential facts, which form the basis for its decision before the final finding is made.

Time-limit for Investigation Process

The normal time allowed by the statute for conclusion of investigation and submission of final findings is one year from the date of initiation of the investigation. The above period may be extended by the Central Government by 6 months.

Termination

The Designated Authority may suspend or terminate the investigation in the following cases:

- (i) if there is a request in writing from the domestic industry at whose instance

the investigation was initiated.

- (ii) when there is no sufficient evidence of dumping or injury.
- (iii) if the margin of dumping is less than 2% of the export price.
- (iv) the volume of dumped imports from a country is less than 3% of the total imports of the like article into India or the volume of dumped imports collectively from all such countries is less than 7% of the total imports.
- (v) injury is negligible.

RETROSPECTIVE MEASURES

The Act provides for levy of anti-dumping duty retrospectively, where-

- (i) there is a history of dumping which caused the injury or that the importer was, or, should have been aware that the exporter practices dumping and that such dumping would cause injury, and
- (ii) the injury is caused by massive dumping, in a relatively short time, so as to seriously undermine the remedial effect of anti-dumping duty. Such retrospective application will not go beyond 90 days of the date of imposition of provisional duty. Further, no retrospective application prior to the date of initiation of investigation is possible.

Review

An anti-dumping duty imposed under the Act shall have the effect for five years from the date of imposition, unless revoked earlier. The Designated Authority shall also review the need for the continued imposition of the anti-dumping duty, from time to time. Such a review can be done suo motu or on the basis of request received from an interested party in view of the changed circumstances. A review shall also follow the same procedures prescribed for an investigation to the extent they are applicable. The Designated Authority is also required to carry out a review for determining margins of dumping for any new exporter or producer from a country that is subject to anti-dumping, provided that these exporters or producers are new and are not related to any of the exporters or producers who are subject to anti-dumping duty on the product.

MISCELLANEOUS PROVISIONS

Appeal

An appeal against the order of the Designated Authority may be filed with the Customs, Excise and Gold (Control) Appellate Tribunal within 90 days of the date of the order.

Refund of Duty

If the anti-dumping duty imposed on the basis of final findings is higher than the provisional duty already imposed and collected, the difference shall not be collected. If the final anti-dumping duty is less than the provisional duty already imposed and collected, the difference shall be refunded. If the provisional duty is withdrawn based on a negative final finding, then the provisional duty already collected shall be refunded.

Products Imported by Units in EPZs/100% EOUs, Advance Licence Holders and by other Exporters

Anti-dumping duty is not payable on products imported by units in EPZs and 100% EOUs, as well as imports on products imported by advance licence holders in terms of Customs notification No. 41/97-Cus dated 30.4.1997. The final anti-dumping duty paid on imported goods used in the manufacture of export goods are liable to be refunded as duty drawback in accordance with the drawback rules.

Applicability of Anti-dumping Duties vis-a-vis other Measures

GATT agreement as well as the Indian laws provide that the injured domestic industry is permitted to file for relief under the anti-dumping as well as countervailing duties. However, no articles shall be subjected to both countervailing and anti-dumping duties to compensate for the same situation of dumping or export subsidization.

INSTITUTIONAL ARRANGEMENT IN INDIA FOR ANTI DUMPING, ANTI-SUBSIDY AND SAFEGUARD ACTION AGAINST UNFAIR TRADE PRACTICES

	<p><i>Anti dumping and anti subsidies & countervailing measures in India are administered by the Directorate General of Anti dumping and Allied Duties (DGAD) functioning in the Dept. of Commerce in the Ministry of Commerce and Industry and the same is headed by the "Designated Authority". The Designated Authority's function, however, is only to conduct the anti dumping/anti subsidy & countervailing duty investigation and make recommendation to the Government for imposition of anti dumping or anti subsidy measures. Such duty is finally imposed/levied by a Notification of the Ministry of Finance. Thus, while the Department of Commerce recommends the Anti-dumping duty, it is the Ministry of Finance, which levies such duty.</i></p>
	<p><i>Safeguard measures, on the other hand, are administered by another Authority namely, Director General (Safeguard), which functions under the Dept. of Revenue, Ministry of Finance. The Standing Board of Safeguards (chaired by the Commerce Secretary) considers the recommendations of the DG (Safeguards) and then recommends the impositions of the Safeguard Duty as it deems fit, to the Ministry of Finance which levies the duty.</i></p>

SIGNIFICANCE OF ANTI DUMPING MEASURES IN INDIA IN THE CONTEXT OF LIFTING OF QUANTITIES RESTRICTION

India is currently in the process of phasing out its quantitative restrictions regime in relation to imports. With removal of licensing restrictions on imports, there has been a tendency on the part of several trading partners of India to resort to dumping of their goods of different kinds into India, thereby creating a situation of unfair competition in the domestic market whereby the domestic industry has suffered injury.

- To address such a scenario of unfair trade, and to provide the requisite

remedy to the domestic industry against injury caused by such dumping, the anti dumping measures have assumed a great deal of significance.

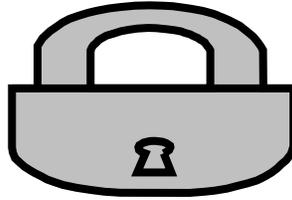
- The anti dumping measures do not aim at providing protection to the domestic industry per se. These are only remedial measures for removal of injury to the domestic industry caused by the dumping of goods. The object behind such measures is to re-establish fair competition and to provide the domestic industry a level playing field.

The paramount objective of the multi-lateral trade regime of WTO is to establish free and fair international trade. With removal of QRs, India has moved towards the regime of free trade. At the same time, anti dumping measures can be applied, where warranted, in the interest of fair trade

LESSON ROUND UP



- Dumping is broadly defined as exporting at prices below those charged in the domestic market or at prices insufficient to cover the cost of the goods sold.
- Dumping can be also characterized as international price discrimination, as predatory pricing or as intermittent dumping.
- Price discrimination implies charging of significantly different product prices to two or more customers when there are no significant differences between the costs to the sellers for supplying to those customers.
- Predatory pricing is the second characterization of dumping that gives rise to an economic rationale for antidumping laws. It consists of systematically pricing below cost with a view to intimidating and eliminating rivals in an effort to bring about a market price higher than otherwise would prevail.
- Intermittent dumping occurs due to oversupply of perishable goods.
- Indian laws were amended with effect from 1.1.1995 to bring them in line with the anti-dumping provisions in WTO Agreement. Anti-dumping duty investigations are carried out under Section 9A of the Customs Tariff Act, 1975 read with Section 9B and the rules made thereunder.
- The paramount objective of the multi-lateral trade regime of WTO is to establish free and fair international trade. With removal of QRs, India has moved towards the regime of free trade. At the same time, anti dumping measures can be applied, where warranted, in the interest of fair trade.

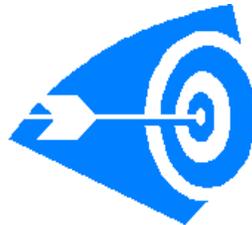
SELF TEST QUESTIONS

1. What do you mean by the term 'Dumping'? Explain the various types of dumping.
 2. Write short notes on:
 - (a) Price discrimination;
 - (b) Predatory pricing;
 - (c) Margin of Dumping.
 3. 'Injury Analysis can be broadly classified into two categories'. Elucidate.
 4. Whether the Designated Authority can suspend or terminate the investigation? Discuss with the help of decided cases.
 5. Explain the procedure for Anti-dumping investigations.
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STUDY XV

ANTI-DUMPING, SUBSIDIES AND COUNTERVAILING DUTIES (SUBSIDIES AND COUNTERVAILING DUTIES)

LEARNING OBJECTIVES



The objective of this study lesson is to enable the students to understand:

- Agreement on Subsidies and Countervailing Measures (SCM Agreement)
- Subsidies and CVDs in SCM
- 'Subsidy' under SCM Agreement
- Categories of Subsidies
- Prohibited Subsidies
- Actionable Subsidies
- Non-Actionable Subsidies
- Agricultural Subsidies
- Countervailing measures
- Substantive Rules
- Duration and review of Countervailing Duties
- Procedural Rules

INTRODUCTION



In common parlance, the term subsidy means money granted by the State or a Public Body to keep the prices of commodities under control. Subsidy may take the form of direct or indirect government grants on production or exportation of goods including any special subsidy on transportation of any product. Subsidy on exports in the exporting country may translate into what is known as Countervailing duty in importing country which is simply a duty on subsidized imports that are found to be hurting domestic producers.

Trade remedies authorized by the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the "Antidumping Agreement") and the Agreement on Subsidies and Countervailing Measures (the "Subsidies

Agreement") form an essential part of the current rules-based international trading system. In Doha, Ministers reinforced the importance of these remedies in their mandate by stating that Members should focus on "preserving the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives, and taking into account the needs of developing and least-developed participants." This underscores the importance of preserving the fundamental principles of the existing trade remedy rules and ensuring that those rules remain effective in addressing the problems of unfair trade confronted by all Members, including developing countries.

Importantly, the Doha Declaration also looks beyond the basic concepts and principles, noting the need to identify "disciplines on trade distorting practices" as part of the scope of the negotiations. Enhanced disciplines on trade-distorting practices must be a central objective in the rules negotiations because these practices are frequently the root cause of unfair trade. While the trade remedy rules remain a necessary response to the trade-distorting practices that continue to burden global trade, enhanced disciplines on trade-distorting practices will provide greater predictability in global trade and reduce the need to resort to trade remedy actions.

Transparency, predictability, and adherence to the rule-of-law are all critical to maintaining confidence in the system, and are particularly important to exporters who may suffer if antidumping and countervailing duty rules are not administered in a fashion consistent with the WTO commitments.

Maintaining confidence in the enforcement of agreed rules and support for further trade liberalization, addressing the harmful effects of trade distorting practices, and eliminating or reducing those practices to the extent possible are essential to the long term viability of the WTO and the economic prosperity of its Members. A critically important component of maintaining confidence in a rules-based trading system is a fully effective dispute settlement system capable of settling disputes without adding to or diminishing the rights and obligations of Members as negotiated in the WTO agreements.

Effective trade remedy instruments are important to respond to and discourage trade-distorting government policies and the market imperfections that result. Ideally, companies and nations would compete in the international marketplace on the basis of real comparative advantages such as natural resource endowments, labour skills and abundance, availability of capital, and technological innovation. Faced with the true relative prices of these production factors, companies and nations would gravitate towards producing and exporting those products in which they have a relative cost advantage and buying/importing those products in which they do not have this advantage. The result would be an efficient allocation of economic resources within countries and an efficient pattern of trade globally that benefits all Members.

However, government attempts to create artificial advantages, distort market signals indicating where the most profitable business opportunities are found. Such distortions can lead to chronic oversupply by inefficient producers on the one hand, and the closure of otherwise efficient and competitive facilities on the other. These problems are not merely academic. The pervasive and persistent nature of inappropriate government involvement is one of the central reasons for chronic

capacity problems in industries such as steel and fisheries. In short, market-distorting practices reduce worldwide economic efficiency, thereby diminishing the gains to all Members from international specialization and exchange based on comparative advantage.

Since Members last took up these issues in a negotiating context, the importance of trade remedies has become clear to a broad universe of Members. Trade liberalization resulting from the Uruguay Round has led to overall increase in trade. However, it has also left markets more open to the effects of unfair trade practices, while adoption of the obligations of the Agreement on Customs Valuation by all Members is resulting in the elimination of less transparent means, that Members previously used to deal with these problems. This is reflected in the substantial growth of the number of countries using trade remedy legislation and their overall share of these measures. In addition, as trade has grown since the Uruguay Round, we have seen an increase in the use of trade remedy laws, particularly by new users. This increased resort to the use of trade remedies underlines the importance of the Ministers' mandate agreed to at Doha.

Trade remedy rules also provide a critical response to government subsidization. There is widespread and longstanding agreement that government subsidies undermine the efficient allocation and utilization of resources. Subsidies therefore undercut, the best foundation of economic growth and development. Export and import-substitution subsidies are particularly troublesome in that they have the most direct impact on trade patterns. It is for this reason these measures are generally prohibited under the GATT/WTO rules.

Countervailing duties have long been accepted as one of the legitimate means of addressing the domestic impact of injurious foreign subsidies. Such measures, however, are only an indirect, partial and temporary remedy to the problems of harmful subsidization. An effective multilateral disciplines regime aimed at reducing and ultimately eliminating distortive subsidies would be the best solution. The Uruguay Round Subsidies Agreement was an important step forward in this regard, but considerable work remains. Many distortive subsidies are so entrenched or disguised within countries' political and economic systems that it will take some time to identify and implement the appropriate multilateral disciplines necessary to root all of them out. The objective of the Rules Group must be the continuation of the progressive strengthening and expansion of disciplines that have marked nearly every round of trade negotiations since the beginning of a rules-based multilateral trading system.

AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES ("SCM AGREEMENT")

The Agreement on Subsidies and Countervailing Measures ("SCM Agreement") addresses two separate but closely related topics: multilateral disciplines regulating the provision of subsidies, and the use of countervailing measures to offset injury caused by subsidized imports. Multilateral disciplines are the rules regarding whether or not a Member may provide a subsidy. They are enforced through invocation of the WTO dispute settlement mechanism. Countervailing duties are a unilateral instrument, which may be applied by a Member after an investigation by that Member and a determination that the criteria set forth in the SCM Agreement are satisfied.

This agreement does two things — it disciplines the use of subsidies, and it regulates the actions countries can take to counter the effects of subsidies. It says a country can use the WTO's dispute settlement procedure to seek the withdrawal of the subsidy or the removal of its adverse effects. Or the country can launch its own investigation and ultimately charge extra duty (known as “countervailing duty”) on subsidized imports that are found to be hurting domestic producers.

The agreement builds on the Tokyo Round Subsidy Code. Unlike its predecessor, the present agreement contains a definition of subsidy. It also introduces the concept of a “specific” subsidy — i.e. a subsidy available only to an enterprise, industry, group of enterprises, or group of industries in the country (or state, etc) that gives the subsidy. The disciplines set out in the agreement only apply to specific subsidies. They can be domestic or export subsidies.

As with anti-dumping, the subsidy agreement is part of the package of WTO agreements that is signed by all members — some GATT members only signed the Tokyo Round “code”.

The agreement defines three categories of subsidies: prohibited, actionable and non-actionable. It applies to agricultural goods as well as industrial products, except when the subsidies conform to the Agriculture Agreement.

SUBSIDIES AND CVDS IN SCM



Article 1 of the Agreement on Subsidies and Countervailing Measures (Agreement on SCM) defines subsidy as involving a financial contribution by a government or any public body within the territory of a member or any form of income or price support which confers a benefit on the recipient.

The ‘financial contribution’ may involve:

- direct transfer of funds in the form of grants, loans or equity infusion or potential direct transfer of funds or liabilities e.g. loan guarantees; or
- forgiveness of government revenue that is otherwise due e.g. fiscal incentives such as tax credits; or
- provision of goods and services, other than general infrastructure or purchase of goods.

Some of the examples of subsidization by the Government include purchase of equity by a Government in a company which may not be expected to give a reasonable return within a certain period, loans at a concessional rate of interest or where the government may stand as a guarantor to a loan, deferment of repayment of loans or interest thereon, deferment of collection of taxes, providing goods or service at prices below those prevailing in the market or purchasing of goods at prices higher than those prevailing in the market etc.

It may, however, be mentioned that exemption of an exported product from

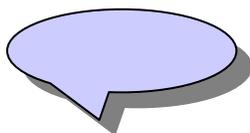
duties or taxes borne by the like product when destined for consumption in the home market or the remission of such duties or taxes in amounts not in excess of those which have incurred is not to be considered as subsidy. Use of duty free inputs in the manufacture or production of export products or removal of export products without payment of duty or allowing drawback of duty on exported production is, therefore, not to be considered as subsidy.

In order that the financial contribution may be considered as a subsidy, the government or a public body must provide it. Financial contribution made by a private body is not to be considered as subsidy unless the private body acts on the direction of the government. Under the Agreement on SCM if a government makes payment to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments then it is to be considered as a subsidy by the government.

The Agreement on SCM categorizes subsidies into Prohibited, Actionable and non-Actionable Subsidies. Further, remedies provided against prohibited subsidies or actionable subsidies and Countervailing Measures can be applied only if the subsidy is specific to an enterprise or industry or a group of enterprises or industries.

Article 2 of the Agreement on SCM provides a subsidy to be treated as specific if its availability is restricted only to the specified recipients i.e. to a specific enterprise or industry or a group of enterprises or industries (referred to as 'certain enterprises').

The following principles may determine whether a subsidy is specific:



- *where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.*
- *where the eligibility for grant of subsidy is governed by objective criteria i.e. which are neutral and do not favour certain enterprises over others, which are economic in nature and horizontal in application, such as number of employees or size of enterprises etc and the eligibility is automatic; specificity shall not exist.*
- *if there are reasons to believe that a subsidy programme, though not specific in accordance with the above principles, in fact is for use by a limited number of certain enterprises or for predominant use of certain enterprises or if the discretion is so used that the benefits flow to certain enterprises, the subsidy shall be specific.*

Subsidies limited to certain enterprises located within a designated geographical

region shall be specific. However, setting or change of generally applicable tax rates by all levels of government entitled to do so is not deemed to be specific subsidy.

STRUCTURE OF THE AGREEMENT

Part I provides that the SCM Agreement applies only to subsidies that are specifically provided to an enterprise or industry or group of enterprises or industries, and defines both the term "subsidy" and the concept of "specificity." Parts II, III and IV divide all specific subsidies into one of three categories — prohibited, actionable, and non-actionable, and establish certain rules and procedures with respect to each category. Part V establishes the substantive and procedural requirements that must be fulfilled before a Member may apply a countervailing measure against subsidized imports. Parts VI and VII establish the institutional structure and notification/surveillance modalities for implementation of the SCM Agreement. Part VIII contains special and differential treatment rules for various categories of developing country Members. Part IX contains transition rules for developed country and former centrally planned economy Members. Parts X and XI contain dispute settlement and final provisions.

Coverage of the Agreement

Part I of the Agreement defines the coverage of the Agreement. Specifically, it establishes a definition of the term "subsidy" and an explanation of the concept of "specificity." Only a measure, which is a "specific subsidy" within the meaning of Part, I is subject to multilateral disciplines and can be subject to countervailing measures.

Calculation of the Amount of Subsidy

For the purpose of Part V, any method used by the investigating authority to calculate the benefit to the recipient conferred pursuant to paragraph 1 of Article 1 shall be provided for in the national legislation or implementing regulations of the Member concerned and its application to each particular case shall be transparent and adequately explained. Furthermore, any such method shall be consistent with the following guidelines:

- (a) government provision of equity capital shall not be considered as conferring a benefit, unless the investment decision can be regarded as inconsistent with the usual investment practice (including for the provision of risk capital) of private investors in the territory of that Member;
- (b) a loan by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market. In this case the benefit shall be the difference between these two amounts;
- (c) a loan guarantee by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the guarantee pays on a loan guaranteed by the government and the amount that the firm would pay on a comparable commercial loan bans

the government guarantee. In this case the benefit shall be the difference between these two amounts adjusted for any differences in fees;

- (d) the provision of goods or services or purchase of goods by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration. The adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question in the country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale).

'Subsidy' under SCM Agreement

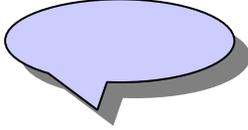
The concept of "financial contribution" was included in the SCM Agreement only after a protracted negotiation. Some Members argued that there could be no subsidy unless there was a charge on the public account. Other Members considered that forms of government intervention that did not involve an expense to the government nevertheless distorted competition and should thus be considered to be subsidies. The SCM Agreement basically adopted the former approach. The Agreement requires a financial contribution and contains a list of the types of measures that represent a financial contribution, e.g., grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services, the purchase of goods. Thus, the SCM Agreement applies not only to measures of national governments, but also to measures of sub-national governments and of such public bodies as state-owned companies.

A financial contribution by a government is not a subsidy unless it confers a "benefit." In many cases, as in the case of a cash grant, the existence of a benefit and its valuation will be clear. In some cases, however, the issue of benefit will be more complex. For example, when does a loan, an equity infusion or the purchase by a government of a good confer a benefit? The SCM Agreement does not provide complete guidance on these issues. In fact, the parties to Uruguay Round negotiations could not agree whether the existence of a benefit should be assessed with reference to a commercial benchmark or with reference to the cost to the subsidizing government. Article 14 of the SCM Agreement states that in a countervailing duty context, the existence of a benefit can (but does not need to) be assessed by reference to a commercial benchmark, and provides some guidance with respect to determining whether certain types of measures confer a benefit. In the context of multilateral disciplines, however, the issue of the meaning of "benefit" is not fully resolved.

Specificity

Assuming that a measure is a subsidy within the meaning of the SCM Agreement, it nevertheless is not subject to the SCM Agreement unless it has been specifically provided to an enterprise or industry or group of enterprises or industries. The basic principle is that a subsidy that distorts the allocation of resources within an economy should be subject to discipline. Where a subsidy is widely available within an economy, such a distortion in the allocation of resources is presumed not to occur. Thus, only "specific" subsidies are subject to the SCM Agreement disciplines.

There are four types of "specificity" within the meaning of the SCM Agreement:



- ***Enterprise-specificity:*** A government targets a particular company or companies for subsidization.
- ***Industry-specificity:*** A government targets a particular sector or sectors for subsidization.
- ***Regional specificity:*** A government targets producers in specified parts of its territory for subsidization.
- ***Prohibited subsidies:*** A government targets export goods or goods using domestic inputs for subsidization.

CATEGORIES OF SUBSIDIES

The SCM Agreement creates three basic categories of subsidies: those that are prohibited, those that are actionable (*i.e.*, subject to challenge in the WTO or to countervailing measures), and those that are non-actionable. All specific subsidies fall into one of these three categories.

Prohibited Subsidies

Article 3 of the SCM Agreement prohibits two categories of subsidies. The first is subsidies contingent, in law or in fact, whether wholly or as one of several conditions, on export performance ("export subsidies"). A detailed list of export subsidies is annexed to the SCM Agreement. The second is subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods ("local content subsidies"). These two categories of subsidies are prohibited because they are designed to affect trade and thus are most likely to have adverse effects on the interests of other Members.

The scope of these prohibitions is relatively narrow. Developed countries had already accepted the prohibition on export subsidies under the Tokyo Round SCM Agreement, and local content subsidies of the type prohibited by the SCM Agreement already were inconsistent with Article III of the GATT 1947. The most significant aspect about the new Agreement in this area is the extension of the obligations to developing country Members in accordance with specified transition rules, as well as the creation in Article 4 of the SCM Agreement of a rapid (three-month) dispute settlement mechanism for complaints regarding prohibited subsidies.

Actionable Subsidies

Most subsidies, such as production subsidies, fall in the "actionable" category. Actionable subsidies are not prohibited. However, they are subject to challenge, either through multilateral dispute settlement or through countervailing action, in the

event that they cause adverse effects to the interests of another Member. There are three types of adverse effects:

- First, there is injury to a domestic industry caused by subsidized imports in the territory of the complaining Member. This is the sole basis for countervailing action.
- Second, there is serious prejudice. Serious prejudice usually arises as a result of adverse effects (e.g., export displacement) in the market of the subsidizing Member or in a third country market. Thus, unlike injury, it can serve as the basis for a complaint related to harm to a Member's export interests.
- Finally, there is nullification or impairment of benefits accruing under the GATT 1994. Nullification or impairment arises most typically where the improved market access presumed to flow from a bound tariff reduction is undercut by subsidization.

The creation of a system of multilateral remedies that allows Members to challenge subsidies which give rise to adverse effects represents a major advance over the pre-WTO regime. The difficulty, however, will remain the need in most cases for a complaining Member to demonstrate the adverse trade effects arising from subsidization, a fact-intensive analysis that panels may find difficult in some cases. To mitigate this problem, the SCM Agreement establishes a sub-category of actionable subsidies with respect to which a rebuttable presumption of serious prejudice exists. In this category are subsidies of greater than 5 per cent *ad valorem*, certain subsidies to cover operating losses, and the direct forgiveness of debt. Subject to the provisions for special and differential treatment for certain Members, a Member need only establish in its complaint that such a subsidy exists, and the subsidizing Member must then demonstrate that its subsidy has not caused serious prejudice to the interests of the complaining Member.

Non-Actionable Subsidies

The SCM Agreement creates three narrowly defined categories of subsidies, which are non-actionable, i.e., which cannot be challenged multilaterally, or is subject to countervailing action. These subsidies presumably are protected either because they are considered extremely unlikely to cause adverse effects or because they are considered to be of particular value and not to be discouraged. The three categories are:

- Basic research and pre-competitive development subsidies. These subsidies cannot exceed a designated proportion of project costs and can only be used for certain expenditures in order to be non-actionable. Research and development subsidies in the civil aircraft sector do not benefit from non-actionable status.
- Assistance to disadvantaged regions. Regional aids are non-actionable provided that they are not limited to specific enterprises or industries within the region, that they are given pursuant to a general scheme of regional development, and that the region is disadvantaged by comparison with the Member as a whole in terms of objective criteria such as GNP *per capita* and unemployment.
- Assistance to adapt existing facilities to new environmental requirements.

Such assistance must be on a one-time basis, be limited to 20 per cent of adaptation costs, and be available to all firms, which can adopt the new equipment and processes.

Subsidy programmes, which are notified to the Committee before they are implemented, are protected unless and until the Committee or arbitration body determines that they do not qualify for non-actionable status. Procedures for arbitration in this area were approved in June 1998. Subsidy programmes which have not been notified before implementation may be investigated by a panel or an investigating authority (in a CVD case) but if found to meet the criteria for non-actionability, shall be treated as non-actionable.

Agricultural Subsidies

The Agreement on Agriculture contains special rules regarding subsidies for agricultural products. The SCM Agreement does not prohibit export subsidies, which are consistent with the reduction commitments in the Agriculture Agreement, although they remain countervailable. Domestic supports consistent with the reduction commitments in the Agriculture Agreement are not actionable multilaterally, although they also may be subject to countervailing duties. Finally, domestic supports within the "green box" of the Agriculture Agreement are neither actionable multilaterally nor are they subject to countervailing measures.

COUNTERVAILING MEASURES

Article 15 specifies how injury can be determined for taking countervailing measures. A determination of injury for purposes of Article VI of GATT 1994 shall be based on positive evidence and involve an objective examination of both

- (a) the volume of the subsidized imports and the effect of the subsidized imports on prices in the domestic market for like products; and
- (b) the consequent impact of these imports on the domestic producers of such products.

With regard to the volume of the subsidized imports, the investigating authorities shall consider whether there has been a significant increase in subsidized imports, either in absolute terms or relative to production or consumption in the importing Member. With regard to the effect of the subsidized imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the subsidized imports as compared with the price of a like product of the importing Member, or whether the effect of such imports is otherwise to depress prices to a significant degree or to prevent price increases, which otherwise would have occurred, to a significant degree. No one or several of these factors can necessarily give decisive guidance.

Where imports of a product from more than one country are simultaneously subject to countervailing duty investigations, the investigating authorities may cumulatively assess the effects of such imports only if they determine that—

- (a) the amount of subsidization established in relation to the imports from each country is more than *de minimis* as defined in paragraph 9 of Article 11 and the volume of imports from each country is not negligible; and

- (b) a cumulative assessment of the effects of the imports is appropriate in light of the conditions of competition between the imported products and the conditions of competition between the imported products and the like domestic product.

The examination of the impact of the subsidized imports on the domestic industry shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry, including actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilization of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital or investments and, in the case of agriculture, whether there has been an increased burden on government support programmes. This list is not exhaustive, nor can one or several of these factors necessarily give decisive guidance.

It must be demonstrated that the subsidized imports are, through the effects of subsidies, causing injury within the meaning of this Agreement. The demonstration of a causal relationship between the subsidized imports and the injury to the domestic industry shall be based on an examination of all relevant evidence before the authorities. The authorities shall also examine any known factors other than the subsidized imports, which at the same time are injuring the domestic industry, and the injuries caused by these other factors must not be attributed to the subsidized imports. Factors which may be relevant in this respect include, *inter alia*, the volumes and prices of non-subsidized imports of the product in question, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry.

The effect of the subsidized imports shall be assessed in relation to the domestic production of the like products, when available data permit the separate identification of that production on the basis of such criteria as the production process, producers' sales and profits. If such separate identification of that production is not possible, the effects of the subsidized imports shall be assessed by the examination of the production of the narrowest group or range of products, which includes the like product, for which the necessary information can be provided.

A determination of a threat of material injury shall be based on facts and not merely on allegation, conjecture or remote possibility. The change in circumstances, which would create a situation in which the subsidy would cause injury, must be clearly foreseen and imminent. In making a determination regarding the existence of a threat of material injury, the investigating authorities should consider, *inter alia*, such factors as:

- (i) nature of the subsidy or subsidies in question and the trade effects likely to arise therefrom;
- (ii) a significant rate of increase of subsidized imports into the domestic market indicating the likelihood of substantially increased importation;
- (iii) sufficient freely disposable, or an imminent, substantial increase in, capacity of the exporter indicating the likelihood of substantially increased subsidized exports to the importing Member's market, taking into account the availability of other export markets to absorb any additional exports;

- (iv) whether imports are entering at prices that will have a significant depressing or suppressing effect on domestic prices, and would likely increase demand for further imports; and
- (v) inventories of the product being investigated.

None of these factors by itself can necessarily give decisive guidance, but the totality of the factors considered must lead to the conclusion that further subsidized exports are imminent and that, unless protective action is taken, material injury would occur.

With respect to cases where injury is threatened by subsidized imports, the application of countervailing measures shall be considered and decided with special care.

Part V of the SCM Agreement sets forth certain substantive requirements that must be fulfilled in order to impose a countervailing measure, as well as in-depth procedural requirements regarding the conduct of a countervailing investigation and the imposition and maintenance in place of countervailing measures. A failure to respect either the substantive or procedural requirements of Part V can be taken to dispute settlement and may be the basis for invalidation of the measure.

SUBSTANTIVE RULES

A Member may not impose a countervailing measure unless it determines that there are subsidized imports, injury to a domestic industry and a causal link between the subsidized imports and the injury. As previously noted, the existence of a specific subsidy must be determined in accordance with the criteria of Part I of the Agreement. However, the criteria regarding injury and causation are found in Part V. One significant development of the new SCM Agreement in this area is the explicit authorization of cumulation of the effects of subsidized imports from more than one Member where specified criteria are fulfilled. In addition, Part V contains rules regarding the determination of the existence and amount of a benefit.

DURATION AND REVIEW OF COUNTERVAILING DUTIES

A countervailing duty shall remain in force only as long as and to the extent necessary to counteract subsidization, which is causing injury. The authorities shall review the need for the continued imposition of the duty, where warranted, on their own initiative or, provided that a reasonable period of time has elapsed since the imposition of the definitive countervailing duty, upon request by any interested party, which submits positive information substantiating the need for a review. Interested parties shall have the right to request the authorities to examine whether the continued imposition of the duty is necessary to offset subsidization, whether the injury would be likely to continue or recur if the duty were removed or varied, or both. If, as a result of the review under this paragraph, the authorities determine that the countervailing duty is no longer warranted, it shall be terminated immediately.

Any definitive countervailing duty shall be terminated on a date not later than five years from its imposition (or from the date of the most recent review under paragraph 2 if that review has covered both subsidization and injury, or under this paragraph), unless the authorities determine, in a review initiated before that date on their own

initiative or upon a duly substantiated request made by or on behalf of the domestic industry within a reasonable period of time prior to that date, that the expiry of the duty would be likely to lead to continuation or recurrence of subsidization and injury. The duty may remain in force pending the outcome of such a review.

The provisions of Article 12 regarding evidence and procedure shall apply to any review carried out under this Article. Any such review shall be carried out expeditiously and shall normally be concluded within 12 months of the date of initiation of the review.

When the authorities are satisfied that there is sufficient evidence to justify the initiation of an investigation pursuant to Article 11, the Member or Members the products of which are subject to such investigation and other interested parties known to the investigating authorities to have an interest therein shall be notified and a public notice shall be given.

A public notice of the initiation of an investigation shall contain, or otherwise make available through a separate report, adequate information on the following:

- (i) the name of the exporting country or countries and the product involved;
- (ii) the date of initiation of the investigation;
- (iii) a description of the subsidy practice or practices to be investigated;
- (iv) a summary of the factors on which the allegation of injury is based;
- (v) the address to which representations by interested Members and interested parties should be directed; and
- (vi) the time-limits allowed to interested Members and interested parties for making their views known.

Public notice shall be given of any preliminary or final determination, whether affirmative or negative, of any decision to accept an undertaking pursuant to Article 18, of the termination of such an undertaking, and of the termination of a definitive countervailing duty. Each such notice shall set forth, or otherwise make available through a separate report, in sufficient detail the findings and conclusions reached on all issues of fact and law considered material by the investigating authorities. All such notices and reports shall be forwarded to the Member or Members the products of which are subject to such determination or undertaking and to other interested parties known to have an interest therein.

A public notice of the imposition of provisional measures shall set forth, or otherwise make available through a separate report, sufficiently detailed explanations for the preliminary determinations on the existence of a subsidy and injury and shall refer to the matters of fact and law which have led to arguments being accepted or rejected. Such a notice or report shall, due regard being paid to the requirement for the protection of confidential information, contain in particular:

- (i) the names of the suppliers or, when this is impracticable, the supplying countries involved;
- (ii) a description of the product which is sufficient for customs purposes;
- (iii) the amount of subsidy established and the basis on which the existence of a

subsidy has been determined;

- (iv) considerations relevant to the injury determination as set out in Article 15;
- (v) the main reasons leading to the determination.

A public notice of conclusion or suspension of an investigation in the case of an affirmative determination providing for the imposition of a definitive duty or the acceptance of an undertaking shall contain, or otherwise make available through a separate report, all relevant information on the matters of fact and law and reasons which have led to the imposition of final measures or the acceptance of an undertaking, due regard being paid to the requirement for the protection of confidential information. In particular, the notice or report shall contain the information described above, as well as the reasons for the acceptance or rejection of relevant arguments or claims made by interested Members and by the exporters and importers.

A public notice of the termination or suspension of an investigation following the acceptance of an undertaking pursuant to Article 18 shall include, or otherwise make available through a separate report, the non-confidential part of this undertaking.

The provisions of this Article shall apply *mutatis mutandis* to the initiation and completion of reviews pursuant to Article 21 and to decisions under Article 20 to apply duties retroactively.

PROCEDURAL RULES

Part V of the SCM Agreement contains detailed rules regarding the initiation and conduct of countervailing investigations, the imposition of preliminary and final measures, the use of undertakings, and the duration of measures. A key objective of these rules is to ensure that investigations are conducted in a transparent manner, that all interested parties have a full opportunity to defend their interests, and that investigating authorities adequately explain the bases for their determinations. A few of the more important innovations in the WTO SCM Agreement are identified below:

- **Standing:** The Agreement defines in numeric terms the circumstances under which there is sufficient support from a domestic industry to justify initiation of an investigation.
- **Preliminary investigation:** The Agreement ensures the conduct of a preliminary investigation before a preliminary measure can be imposed.
- **Undertakings:** The Agreement places limitations on the use of undertakings to settle CVD investigations, in order to avoid Voluntary Restraint Agreements or similar measures masquerading as undertakings.
- **Sunset:** The Agreement requires that a countervailing measure be terminated after five years unless it is determined that continuation of the measure is necessary to avoid the continuation or recurrence of subsidization and injury.
- **Judicial review** The Agreement requires that Members create an independent tribunal to review the consistency of determinations of the investigating authority with domestic law.

SUBSIDIES IN AGREEMENT ON AGRICULTURE

The proliferation of export subsidies in the years leading to the Uruguay Round was one of the key issues that were addressed in the agricultural negotiations. While under the GATT 1947 export subsidies for industrial products have been prohibited all along, in the case of agricultural primary products such subsidies were only subject to limited disciplines (Article XVI of GATT), which moreover did not prove to be operational.

The right to use export subsidies is now limited to four situations: (i) export subsidies subject to product-specific reduction commitments within the limits specified in the schedule of the WTO Member concerned; (ii) any excess of budgetary outlays for export subsidies or subsidized export volume over the limits specified in the schedule which is covered by the “downstream flexibility” provision of Article 9.2(b) of the Agreement on Agriculture; (iii) export subsidies consistent with the special and differential treatment provision for developing country Members (Article 9.4 of the Agreement); and (iv) export subsidies other than those subject to reduction commitments provided that they are in conformity with the anti-circumvention disciplines of Article 10 of the Agreement on Agriculture. In all other cases, the use of export subsidies for agricultural products is prohibited (Articles 3.3, 8 and 10 of the Agreement).

Definition of measures

Under the Agreement on Agriculture export subsidies are defined as referring to “subsidies contingent on export performance, including the export subsidies listed in detail in Article 9 of [the] Agreement”. As specified in more detail in Article 9.1 of the Agreement, this list covers most of the export subsidy practices which are prevalent in the agricultural sector, notably:

- Direct export subsidies contingent on export performance;
- Sales of non-commercial stocks of agricultural products for export at prices lower than comparable prices for such goods on the domestic market;
- Producer financed subsidies such as government programmes which require a levy on all production which is then used to subsidise the export of a certain portion of that production;
- Cost reduction measures such as subsidies to reduce the cost of marketing goods for export: this can include upgrading and handling costs and the costs of international freight;
- Internal transport subsidies applying to exports only, such as those designed to bring exportable produce to one central point for shipping;
- Subsidies on incorporated products, i.e. subsidies on agricultural products such as wheat contingent on their incorporation in export products such as biscuits; and
- All such export subsidies are subject to reduction commitments, expressed in terms of both the volume of subsidized exports and the budgetary outlays for these subsidies.

Product categories

The reduction commitments are shown in the schedules of WTO Members on a product-specific basis. For this purpose, the universe of agricultural products was initially divided into 23 products or product groups, such as wheat, coarse grains, sugar, beef, butter, cheese and oilseeds. Some Members took commitments on a more disaggregated level. The volume and budgetary outlay commitments for each product or group of products specified in a Member's schedule are individually binding. The reduction commitments on "incorporated products" (last item in the Article 9 list) are expressed in terms of budgetary outlays only. The ceilings specified in the schedules must be respected in each year of the implementation period although limited "over-shooting" in the second to fifth year of implementation is permitted ("downstream flexibility"). By the last year of the implementation period, Members must be within their final export subsidy ceilings.

Products with no specific reduction commitment

The Agreement on Agriculture prohibits the use of Article 9.1 export subsidies on any agricultural product, which is not subject to a reduction commitment as specified in the relevant part of the Member's schedule (with the exception, during the implementation, period of those benefiting from special and differential treatment).

Anti-circumvention

In addition to the provisions directly related to the reduction commitments, the Agreement on Agriculture contains provisions, which are designed to prevent the use of export subsidies that are not specifically listed in Article 9 of the Agreement in such a way as to circumvent reduction on other export subsidy commitments (Article 10). The anti-circumvention provisions include a definition of food aid in order that transactions claimed to be food aid, but not meeting the criteria in the Agreement, cannot be used to undermine commitments. Food aid that meets the specified criteria is not considered to be subsidised export hence is not limited by the Agreement on Agriculture. The Agreement also calls for the development of internationally agreed disciplines on export credits and similar measures in recognition that such measures could also be used to circumvent commitments. Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.

Notification obligations

All Members must notify the Committee on Agriculture annually with respect to export subsidies. For the vast majority of Members — those without reduction commitments — this involves only a statement to the effect that export subsidies on agricultural products have not been used (or a listing of those measures that may be used by developing country Members under Article 9.4 of the Agreement if this has been the case). For Members with reduction commitments in their schedules, the annual notification must contain the annual use of subsidies in terms of both volume and budgetary outlays.

In addition, as part of the anti-circumvention provisions, Members must notify the

use of food aid on an annual basis if such aid is granted. Likewise, Members must notify total exports of agricultural products with reduction commitments as well as by a number of other "significant exporters" as defined by the Committee.

As in other areas, the export subsidy notifications form part of the basis for reviewing the progress in the implementation of the commitments by the Committee on Agriculture.

EXPORT SUBSIDY ON AGRICULTURE

Up to 1995, GATT rules were largely ineffective in disciplining agricultural trade. In particular, export subsidies came to dominate many areas of world agricultural trade, while the disciplines on import restrictions were often flouted. The 1986–1994 Uruguay Round went a long way towards changing all that.

The trade is now firmly within the multilateral trading system. The Agriculture Agreement, together with individual countries' commitments to reduce export subsidies, domestic support and import barriers on agricultural products make up a comprehensive programme for reforming agricultural trade.

The reform programme struck a balance between agricultural trade liberalization and governments' desire to pursue legitimate agricultural policy goals, including non-trade concerns. The reform brought all agricultural products (as listed in the agreement) under multilateral disciplines, including "tariff bindings" — WTO members have bound themselves to maximum tariffs on nearly all agricultural products, while many industrial tariffs remain unbound.

WTO members also agreed (Article 20 of the Agriculture Agreement) to reopen negotiations in agriculture at the end of this year in order to continue the reform programme.

In the run up to the Seattle ministerial and the new negotiations, the following issues are among those that have been raised.

Continuing reductions: the objective

Further substantial reductions in tariffs, domestic support and export subsidies can be expected to be the main focus of the negotiations. In addition, some countries say an important objective of the new negotiations should be to bring agricultural trade under the same rules and disciplines as trade in other goods. Some others, mainly developed countries, reject the idea for a number of reasons.

Market access: tariffs and tariff quotas

Nowadays, all agricultural products are protected only by tariffs. All non-tariff barriers had to be eliminated or converted to tariffs as a result of the Uruguay Round (the conversion is known as "tariffication"). In some cases, the calculated equivalent tariff was too high to allow any real opportunity for imports. So a system of tariff-rate quotas was created to maintain existing import access levels, and to provide minimum access opportunities. This means lower tariffs within the quotas, and higher rates for quantities outside the quotas.

The discussion since the Uruguay Round has focused broadly on two issues: the

high levels of tariffs outside the quotas (with some countries pressing for larger cuts on the higher tariffs), and the quotas themselves — their size and the way they have been administered.

Quota administration is a technical subject, but it has a real impact on trade — on whether a product exported from one country can gain access to the market of another country at the lower, within-quota tariff.

Methods used for giving exporters access to quotas include first-come, first-served allocations, import licensing according to historical shares and other criteria, administering through state trading enterprise, bilateral agreements, and auctioning. Exporters are sometimes concerned that their ability to take advantage of tariff quotas can be handicapped because of the way the quotas are administered.

Each method has advantages and disadvantages, and many WTO members acknowledge that it can be difficult to say conclusively whether one method is better than another. Several countries want the negotiations to deal with tariff quotas: to replace them with low tariffs, to increase their size, or to sort out what they consider to be restricting and non-transparent allocation methods.

Market access: special agricultural safeguards

Safeguards are contingency restrictions on imports taken temporarily to deal with special circumstances such as a surge in imports. They normally come under the Safeguards Agreement, but the Agriculture Agreement has special provisions (Article 5) on safeguards.

The special safeguards provisions for agriculture differ from normal safeguards in agriculture, unlike with normal safeguards:

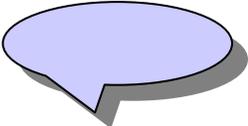
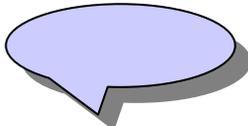
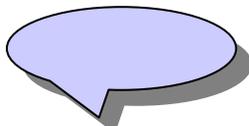
- higher safeguards duties can be triggered automatically when import volumes rise above a certain level, or if prices fall below a certain level; and
- it is not necessary to demonstrate that serious injury is being caused to the domestic industry.

The special agricultural safeguard can only be used on products that were tariffed, but not on imports within the tariff quotas, and only if the government reserved the right to do so in its schedule of commitments on agriculture.

Proposals for the negotiations range from continuing with the provision in its current form, to its abolition, or its revision to prevent its use on products from developing countries. However, the right to use the special agricultural safeguard would lapse if there is no agreement in the negotiations after Seattle to continue the “reform process” initiated in the Uruguay Round.

Domestic Support

In WTO terminology, “boxes” which are given the colours of traffic lights in general identify subsidies: green (permitted), amber (slow down — i.e. be reduced), red (forbidden). In agriculture, things are, as usual, more complicated. The Agriculture Agreement has no red box, but there is a blue box for certain types of subsidies, and exemptions for developing countries (sometimes called an “S&D box”).

<p style="text-align: center;">THE 'AMBER BOX'</p> 	<p style="text-align: center;">THE 'GREEN BOX'</p> 	<p style="text-align: center;">THE 'BLUE BOX'</p> 
<p>For agriculture, all subsidies and other domestic support measures considered to distort production and trade (with some exceptions) fall into the amber box. The total value of these measures must be reduced.</p>	<p>In order to qualify for the "green box", a subsidy must not distort trade, or at most cause minimal distortion. They have to be government-funded (not by charging consumers higher prices) and must not involve price support. They tend to be programmes that are not directed at particular products, and include direct income supports for farmers that are not related to (are "decoupled" from) production. "Green box" subsidies are therefore allowed without limits, provided they comply with relevant criteria.</p> <p>Some countries say they would like to review the domestic subsidies listed in the green box because they believe that some of these, in certain circumstances, could have an influence on production or prices. Some others, including some major players advocating general agricultural trade liberalization, have said that the green box should not be changed because it is already satisfactory.</p>	<p>The blue box is an exemption from the general rule that all subsidies linked to production must be reduced or kept within defined minimal ("<i>de minimis</i>") levels. It covers payments directly linked to acreage or animal numbers, but under schemes, which also limit production, by imposing production quotas or requiring farmers to set aside part of their land. Countries using these subsidies say they distort trade less than alternative amber box subsidies.</p> <p>At the moment, the blue box is a permanent provision of the agreement. Some countries want it scrapped because the payments are only partly decoupled from production. Others say it is an important tool for supporting and reforming agriculture, and for achieving certain "non-trade" objectives.</p>

Export subsidies

Some countries are proposing the total elimination of export subsidies. Others reject the idea. In addition, some countries would like to examine the rules to prevent governments getting around (“circumventing”) their commitments — including the use of state trading enterprises and subsidized export credits.

Developing countries

Developing countries reflect a range of interests in the debate on agriculture, and the distinctions are not always clear.

Most members of the Cairns Group — which favours much greater liberalization in agricultural trade — are developing countries. But like most WTO members, the Cairns Group would also like to see developing countries given “special and differential” treatment to take account of their needs.

Some countries say WTO arrangements should be more flexible so that developing countries can support and protect their agricultural and rural development and ensure the livelihoods of their large agrarian populations.

They argue, for example, that subsidies and protection are needed to ensure food security, to support small scale farming, to make up for a lack of capital, or to prevent the rural poor from migrating into already over-congested cities.

At the same time, some developing countries make a clear distinction between their needs and what they consider to be the desire of much richer countries to spend large amounts subsidizing agriculture at the expense of poorer countries.

Many developing countries complain that their exports still face high tariffs and other barriers in developed countries’ markets and that their attempts to develop processing industries are hampered by tariff escalation (higher import duties on processed products compared to raw materials). They want to see substantial cuts in these barriers.

Decision on net-food importing developing countries

A number of developing countries which depend on imports for their food supply are also concerned about possible rises in world food prices as a result of reductions in richer countries’ subsidies. Although they accepted that higher prices can benefit farmers and increase domestic production, they feel that their concerns about food imports need to be addressed more effectively.

The WTO agreements include a *Decision on the Possible Negative Effects of the Reform Programme on Least-Developed and Net-Food Importing Developing Countries*. As a result of this decision the Food Aid Convention was recently renegotiated and concluded in July 1999 in the International Grains Council. The WTO Committee on Agriculture also regularly reviews actions within the framework of the decision, in such areas as technical and financial assistance provided to least-developed and net-food importing countries to assist in improving their agricultural productivity and infrastructure.

'NON-TRADE' CONCERNS AND 'MULTIFUNCTIONALITY'

The Agriculture Agreement includes provisions for important "non-trade" concerns such as food security, the environment, structural adjustment (which can include rural development) and so on.

Most countries accept that agriculture is not only about producing food and fibre but also has other functions, including these non-trade objectives — although some dislike the buzzword "multifunctionality". The question debated in the WTO is whether "trade-distorting" subsidies, or subsidies outside the "green box", are needed in order to help agriculture perform its many roles.

Some countries say all the objectives can and should be achieved more effectively through "green box" subsidies, which are targeted directly at these objectives. Examples include direct payments to producers, structural adjustment assistance, environmental programmes, and regional assistance programmes, which do not stimulate agricultural production or affect prices. These countries say the onus is on the proponents of non-trade concerns and "multifunctionality" to show that the existing provisions, which were the subject of lengthy negotiations in the Uruguay Round, are inadequate for dealing with these concerns in targeted, non-trade distorting ways.

Other countries say the non-trade concerns are closely linked to production. They believe subsidies based on, or related to, production are needed for these purposes. For example, rice fields have to be promoted in order to prevent soil erosion, they say. A number of countries have produced studies to support their arguments, and these studies have also been debated.

Many exporting developing countries say multifunctionality is a form of special and differential treatment for rich countries. Several even argue that any economic activity — industry, services and so on — is equally multifunctional, and therefore if the WTO is to address this issue, it has to do so in all areas of the negotiations, not only agriculture. Some others say agriculture is special.

The peace clause

Article 13 ("due restraint") of the Agriculture Agreement protects countries using subsidies, which comply with the agreement from being challenged under other WTO agreements. Without this "peace clause", countries would have greater freedom to take action against each others' subsidies, under the Subsidies and Countervailing Measures Agreement and other provisions. The peace clause is due to expire at the end of 2003.

Some countries want it extended so that they can enjoy some degree of "legal security", ensuring that they will not be challenged so long as they comply with their commitments under the Agriculture Agreement.

Others want it to lapse as part of their overall objective to see agriculture brought under general WTO disciplines, although they might be prepared to consider an extension, depending on what is agreed in other parts of the agriculture negotiation.

Fisheries and forestry

The Agriculture Agreement does not include fishery and forestry products. Some WTO members would like to see specific disciplines negotiated for these products and have tabled proposals for Seattle.

In particular there are proposals for dealing with fisheries subsidies (both for fishing fleets and for fish farming) and their impact on fish stocks and the environment. The proposed rules and disciplines for forestry products would include the promotion of resource conservation and management, other environmental concerns, and disciplines on market access and export restrictions on logs.

The proposals would almost certainly not come under the Agriculture Agreement.

Article 20 and beyond

Article 20 of the Agriculture Agreement says WTO members have to negotiate to continue the reform programme for agriculture.

Members generally accept that this should result in better market conditions, lower production distorting subsidies and reductions in export subsidies. However, there is no agreement about the depth of these reforms (how deep the cuts in subsidies and tariffs should go, and how far the quotas should be widened) or on how issues like some non-trade concerns should be addressed.

The forthcoming negotiations will be difficult but they will also contribute to further liberalization of agricultural trade. This will benefit those countries, which can compete on quality and price rather than on the size of their subsidies. This is particularly the case for many developing countries whose economies depend on an increasingly diverse range of primary and processed agricultural products

Article 20 of the Agriculture Agreement*Continuation of the Reform Process*

Recognizing that the long-term objective of substantial progressive reductions in support and protection resulting in fundamental reform is an ongoing process, Members agree that negotiations for continuing the process will be initiated one year before the end of the implementation period, taking into account:

- (a) the experience to that date from implementing the reduction commitments;
- (b) the effects of the reduction commitments on world trade in agriculture;
- (c) non-trade concerns, special and differential treatment to developing-country Members, and the objective to establish a fair and market-oriented agricultural trading system, and the other objectives and concerns mentioned in the preamble to this Agreement;
- (d) and what further commitments are necessary to achieve the above mentioned long-term objectives.

Issues Common to the Agreement on Subsidies and Countervailing Measures and the Anti Dumping Activities

Industry Support Requirements: Currently, the ADA and ASCM require that an application for an investigation must: a) be supported by domestic producers whose

collective output constitutes more than 50 percent of the total production of like products produced by that portion of the domestic industry expressing either support for or opposition to the application; and b) represent at least 25 percent of the total production of the like product produced by the domestic industry. There has been controversy over the past several years regarding whether the current industry support requirements as reflected in both the ADA and ASCM, are adequate. Certain countries will likely propose changes to the level of industry support required for an application to initiate a countervail or anti-dumping investigation. Proposals will likely also be made for new rules to ensure that the level of industry support for an application is objectively determined, free of direct or indirect government discretion.

Insignificant Margin of Dumping or Amount of Subsidy: The ASCM and the ADA require that an investigation be terminated with respect to certain goods, if the amount of subsidy or the margin of dumping is *de minimis* (i.e., insignificant). *De minimis* is defined in the Agreements as a subsidy of less than 1% of the export price, or a margin of dumping of less than 2% of the export price. In countervail investigations, for imports from developing country Members; *de minimis* is defined to be less than 2%, expressed as a percentage of the export price. Members will likely consider whether existing thresholds are appropriate both from a development and generic perspective.

Negligible volume level: The ADA requires that investigations be terminated with respect to goods of a country when the dumped imports from that country represent less than 3% of the total imports of the like products in the importing country, unless countries, whose dumped imports that individually account for less than 3%, collectively account for more than 7% of the total imports of like products in the importing country. The ASCM requires that an investigation be terminated if the volume of subsidized imports or the injury is "negligible"; however, the ASCM does not define the term negligible, except in relation to imports from developing country Members, for which the volume of subsidized imports is negligible if they individually account for less than 4%, or collectively account for less than 9% of the total imports of like products in the importing country. Members will likely consider whether existing thresholds are appropriate both from a development and generic perspective.

Injury Issues: The provisions of Article 3 of the ADA and Article 15 of the ASCM, which concern the determination of injury and whether dumping or subsidizing caused such injury, have been the subject of numerous disputes. A range of issues are likely to be proposed for clarification or improvement including: the factors to be considered in determining whether an industry has suffered material injury and whether there are factors that must always be considered; the circumstances justifying a cumulative assessment of the effects of dumped or subsidized imports from more than one exporting country; the conditions of competition that are relevant to a determination of whether a cumulative injury assessment would be appropriate; the factors to be considered in determining whether a threat of material injury exists; and more detailed factors to be considered when establishing a causal linkage requirement between the dumped/subsidized imports and material injury.

Public Interest and Lesser Duty: Articles 9.1 of the ADA and 19.2 of the ASCM establish the general principle that imposition of anti-dumping or countervailing duties is optional, even if all the requirements for imposition have been met, and establishes

the desirability of the application of a "lesser duty", i.e., less than the full margin of dumping or amount of subsidy. Several WTO Members, including Canada, have experience with lesser duty provisions. In Canada this has been done in the context of public interest considerations and we will be looking for other WTO members to adopt similar practices.

Duty Enforcement Methodologies: The ADA and ASCM provide for two basic approaches to duty assessment. In general terms, prospective enforcement involves the assessment of final duties when the goods are accounted for upon importation. Retrospective assessment, on the other hand, involves the posting of deposits to cover estimated duties on individual import entries, with final duties being assessed in a subsequent review of those entries. The Agreements do not, however, provide detailed rules respecting how these methods are to be applied. Most Members employ a prospective system, which provides a measure of predictability for exporters and importers by affording them with the opportunity to sell the exported goods at a price that will not create a margin of dumping. The United States uses a retrospective approach, which assesses an estimated amount of duties at the time of importation, with final duty liability only being established in a subsequent administrative review, which is usually conducted on a yearly basis. The review can result in additional, unforeseen duty liability. As such, it may be useful to examine greater convergence between duty enforcement methodologies or the adoption of a single prospective method of duty assessment.

With regard to the Agreement on Subsidies and Countervailing Measures in the WTO, Venezuela had put forth a proposal that the subsidy measures implemented by developing countries to achieve legitimate goals such as regional growth, technology research and development funding, production diversification and development and implementation of environmentally sound methods of production be treated as non-actionable. The Doha Decision takes note of this proposal and places it among outstanding implementation issues on which the subsidies and countervailing Measures Committee must report to the Trade Negotiating Committee by the end of 2002. It urges members to 'exercise due restraint with respect to challenging such a measure' in the interim.

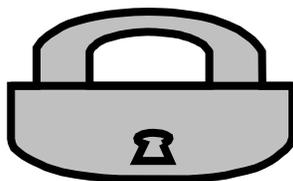
LESSON ROUND UP



- In common parlance, the term subsidy means money granted by the State or a Public Body to keep the prices of commodities under control. Subsidy may take the form of direct or indirect government grants on production or exportation of goods including any special subsidy on transportation of any product.
- The Agreement on Subsidies and Countervailing Measures ("SCM Agreement") addresses two separate but closely related topics: multilateral disciplines regulating the provision of subsidies, and the use of countervailing measures to offset injury caused by subsidized imports.

- The SCM Agreement creates three basic categories of subsidies: prohibited, actionable (*i.e.*, subject to challenge in the WTO or to countervailing measures), and non-actionable. All specific subsidies fall into one of these three categories.
- Article 15 specifies how injury can be determined for taking countervailing measures.
- In WTO terminology, “boxes” which are given the colours of traffic lights in general identify subsidies: green (permitted), amber (slow down — *i.e.* be reduced), red (forbidden). In agriculture, things are, as usual, more complicated. The Agriculture Agreement has no red box, but there is a blue box for certain types of subsidies, and exemptions for developing countries (sometimes called an “S&D box”).
- A determination of injury is based on positive evidence and involve an objective examination of both
 - (a) the volume of the subsidized imports and the effect of the subsidized imports on prices in the domestic market for like products; and
 - (b) the consequent impact of these imports on the domestic producers of such products.

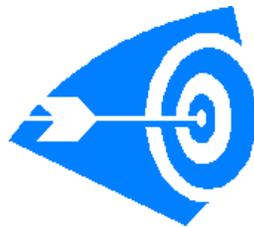
SELF TEST QUESTIONS



1. 'The SCM Agreement creates three basic categories of subsidies'. Explain briefly.
 2. What are the types of 'specificity' that come within the ambit of SCM Agreement?
 3. Write a self-contained note on the duration and review of countervailing duties.
 4. What are the three boxes in agriculture agreement?
 5. Briefly discuss duration and review of countervailing duties.
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STUDY XVI
SETTLEMENT OF DISPUTES UNDER WTO

LEARNING OBJECTIVES



The objective of this study lesson is to enable the students to understand:

- The Dispute Settlement System under WTO
- Right and obligations of WTO Members
- Central Concept of Nullification or Impairment
- WTO dispute settlement process
- Selection and Appointment of Panelists for Dispute Settlement
- Expert Review Group
- Role of the Director – General in Dispute Settlement Procedure
- Dispute Settlement and Developing Countries

INTRODUCTION

The Dispute Settlement Understanding (DSU) is often seen as one of the most important achievements in the World Trade Organization (WTO) Agreement. While the GATT also contained provisions for conflict resolution, the DSU contains a number of innovations. In particular, it is generally seen as being superior to its predecessors in terms of the clarity of its provisions concerning procedural matters, and its provisions establishing a monitoring scheme to overview implementation. Recently, however, criticism has been voiced concerning the possibilities for poorer countries to take full advantage of the system.

Renato Ruggiero, former WTO director general, called the dispute settlement procedure the WTO's most individual contribution to the stability of the global economy. No review of the achievements, of the WTO would be complete without mentioning the Dispute Settlement system which is in many ways the central pillar of the multilateral trading system. The new WTO system is at once stronger, more automatic and more credible than its GATT predecessor. This is reflected in the increased diversity of countries using it and in the tendency to resolve cases 'out of court' before they get to the final decision - 19 out of 71 cases so far. The system is working as intended - as a means above all for conciliation and for encouraging resolution of disputes, rather than just for making judgments. By reducing the scope

for unilateral actions, it is also an important guarantee of fair trade for [less powerful countries]. Without enforcement, the rules-based system would be worthless. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. It is clearly structured, with flexible timetables set for completing a case. A panel makes first rulings. Appeals based on points of law are possible. All final rulings or decisions are made by the WTO's full membership. No single country can block these.

Under the GATT system, the establishment of panel to adjudicate the dispute and the adoption of the panel report could be done only by the consensus of the Members. This provision of positive consensus often led to the blockage of the settlement procedure either at the stage of establishment of panel or at the stage of adoption of panel report. This was one of the main causes of the failure of the GATT system in the settling trade disputes in a time bound manner.

The above-mentioned flaw can be best understood with the help of two cases. In 1988, the US imposed sanctions against imports from Brazil under Super 301 Trade Act of 1974 on the ground that Brazil has failed to give patent protection to pharmaceutical products produced by US companies. Brazil filed a complaint against the US stating that their step was GATT-illegal, and requested for a dispute settlement panel in this regard. The US blocked the constitution of the panel, by using its influence, for over six months. The US, however, lifted the sanction after a bilateral understanding with Brazil. In the Canned fruit case, the US brought a complaint against the European Communities (EC) with respect to their programme of subsidising domestic producers. A panel was established in this regard in June 1982. The panel gave its decision in favour of the US in 1983. The panel report, however, could not be adopted due to EC's opposition. The US withdrew the report from the GATT agenda after it reached an agreement with the EC. There are many such instances where either the panel could not be established or the report was not adopted due to inherent ambiguity in the GATT dispute settlement system. In majority of these cases the parties reached a settlement, with scant attention to the legal process. To address this issue, the provision of negative consensus is introduced in the DSU. This means that under the new system panel report shall be adopted automatically unless it is rejected by consensus.

Similar provision is for the establishment of the panel. In simple words, before the Uruguay Round, consensus was needed at each stage of the dispute settlement process, while at the WTO consensus against each stage of the process is needed. Furthermore, under the GATT system, aggrieved parties could legally invoke their domestic laws (for example Super 301 of the US) by successfully blocking the multilateral process. Thus, the basic philosophy of the multilateral trading system (i.e. to check unilateralism) could not be fulfilled in its entirety under the GATT system. On the contrary, under the WTO system, the blockage of panel report is next to impossible and hence the threat of aggressive unilateralism is minimum. Also, there is a time frame for each and every stage of the legal process. Thus, delaying tactics, as adopted by some members in the past, is virtually impossible under the new system. In effect, the principle of negative consensus means that a wronged member can expect to receive compensation within a year to eighteen months (twelve months maximum, on appeal, and nine months normally).

CENTRAL ROLE IN THE SECURITY AND PREDICTABILITY OF WTO MULTILATERAL TRADING SYSTEM

The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system resulting from the Uruguay Round (Article 3.2 DSU). Its aim is to secure a positive solution to a dispute. The purpose of the WTO Understanding on Rules and Procedures Governing the Settlement of Disputes (the "DSU") is to provide for an efficient, dependable and rule-oriented system to resolve, within a multilateral framework, disputes arising in relation to the application of the Marrakesh Agreement Establishing the World Trade Organization. Throughout this description, the Marrakesh Agreement establishing the World Trade Organization, including its annexes, will be referred to as the "WTO Agreement", whereas the agreements composing it will be referred to as the "WTO agreements".

The DSU promotes the use of a multilateral system of dispute settlement in place of unilateralism in the resolution of trade conflicts (Article 23.1 DSU). This multilateral system is based on the principles for the management of disputes developed under Articles XXII and XXIII of GATT 1947, as further elaborated and modified by the DSU (Article 3.1 DSU).

RULE-BASED SYSTEM



The WTO dispute settlement mechanism is a rule-oriented system where recommendations and rulings must aim at achieving a satisfactory settlement in accordance with the rights and obligations of the Members under the WTO Agreement. As a result, all solutions to matters formally raised under the consultation and dispute settlement provisions of the WTO agreements must not nullify and impair benefits accruing to any Member under those agreements

Under the DSU, the "players" in a dispute settlement process are subject to certain rules aimed at ensuring due process and unbiased recommendations and rulings. For instance, there must not be any *ex parte* communications with the panel or Appellate Body members concerning matters under consideration by the panel or the Appellate Body (Article 18.1 DSU).

Rules of Conduct for the Understanding on Rules and Procedures Governing the Settlement of Disputes (WT/DSB/RC/1, 3 December 1996, the "Rules of Conduct") are applicable to panel members, Appellate Body members, experts assisting panels, arbitrators, Secretariat staff and members of the Textile Monitoring Body, referred to as "covered persons".

Under the Rules of Conduct, covered persons are required to be independent and impartial, to avoid direct or indirect conflicts of interest, and to respect the confidentiality of proceedings of bodies pursuant to the dispute settlement mechanism, in order to ensure that the integrity and impartiality of that mechanism is maintained. In particular the covered persons are required to disclose the existence or development of any interest, relationship or matter that he or she could reasonably

be expected to know and that is likely to affect, or give rise to justifiable doubts as to that person's independence or impartiality. Such disclosure has to include information on financial, professional and other active interest as well as considered statements of public opinion and employment or family interests.

If it is not possible to reach a mutually agreed solution, the first objective of the dispute settlement system is normally to secure the withdrawal of the measures concerned if they are found to be inconsistent with the WTO Agreement (Article 3.7 DSU).

The prompt settlement of situations in which a Member considers that benefits accruing to it directly or indirectly under the WTO Agreement are being impaired by measures taken by another member is essential to the effective functioning of the WTO; and the maintenance of a proper balance between the rights and obligations of its Members (Article 3.3 DSU).

Efficiency is achieved through detailed procedural provisions, including provisions, which allow a party to move forward with the case even in the absence of agreement of the other party (e.g. Article 4.3 or Article 6.1 DSU).

The procedures for dispute settlement, which are laid down in the DSU, have many features, which make it quasi-judicial in nature. First, there is assured access to these procedures. Second, there is near automaticity in decision-making in all key issues related to settlement of individual disputes. Third, firm time limits are stipulated for each stage of the process. And finally, there is provision for appellate review.

Exclusive Application of WTO Rules on Dispute Settlements

The WTO dispute settlement provisions are composed of a set of internationally agreed rules to which WTO Members must have recourse where they seek redress of the effects of measures of other WTO Members under the WTO agreements (Article 23.1 DSU), i.e. when they allege:

- (i) a violation of obligations or other nullification or impairment of benefits under the agreements; or
- (ii) an impediment to the attainment of any objective of the agreements.

When a Member seeks redress of the effects of measures of other Members under the WTO Agreement, it must not determine that any of the situations under (i) or (ii) above exists except through recourse to dispute settlement in accordance with the rules and procedures of the DSU. It must make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or in an arbitration award rendered under the DSU (Article 23.2(a) DSU). It has also to respect the relevant procedures under the DSU with respect to the implementation of recommendations and rulings and suspension of concessions or other obligations (Article 23.2(b) and (c) DSU).

Uniform application to all WTO Agreements

Subject to certain conditions and exceptions, the DSU is applicable in a uniform manner to disputes under all of the WTO Agreements. The rules and procedures under the DSU apply to all disputes brought pursuant to the consultation and dispute

settlement provisions of the WTO agreements listed in Appendix 1 DSU, subject to such special or additional rules and procedures on dispute settlement contained in the covered agreements (Article 1.2 and Appendix 2 DSU). To the extent that there is a difference between the rules and procedure of the DSU and the special and additional rules and procedures, the latter prevails (Article 1.2 DSU).

The DSU is, in principle, applicable to disputes under any of the WTO agreements, taken individually or in combination (Article 1.1 DSU). The list of the agreements to which the DSU applies is contained in Appendix 1 DSU. They are referred to as the "covered agreements" in the DSU. The DSU is applicable to the resolution of disputes under the Marrakesh Agreement Establishing the World Trade Organization, as well as all the agreements annexed thereto subject, for some of them, to special or additional rules and procedures contained in Appendix 2 DSU. Many matters brought before the DSB include alleged violations of more than one covered agreement. In *European Communities - Regime for the Importation, Sale and Distribution of Bananas, complaint by Ecuador, Guatemala, Honduras, Mexico and the United States (WT/DS27)*, for instance, the matter included alleged violations of GATT 1994, the Import Licensing Agreement, the Agreement on Agriculture, the TRIMs Agreement and the GATS.

The covered agreements include the Plurilateral Trade Agreements contained in Annex 4 to the Marrakesh Agreement Establishing the World Trade Organization (Appendix 1 DSU). However, the applicability of the DSU to the Plurilateral Trade Agreements is subject to the adoption of a decision by the parties to each of these agreements setting out the terms for the application of the Understanding to the individual agreement, including any special and additional rules or procedures (Appendix 1 DSU). The Committee of the Agreement on Government Procurement took such a decision. The Committee on Trade in Civil Aircraft has adopted no such decision.

PRESERVING THE RIGHTS AND OBLIGATIONS OF WTO MEMBERS

The WTO dispute settlement system serves to preserve the rights and obligations of Members under the WTO Agreement and to clarify the existing provisions of the WTO Agreement in accordance with customary rules of interpretation of public international law (Article 3.2 DSU). This is without prejudice to the rights of Members to seek authoritative interpretation of provisions of a WTO agreement through decision-making under the WTO Agreement (Article IX: 2 Marrakesh Agreement Establishing the World Trade Organization) or, where applicable, a Plurilateral Trade Agreement (Article 3.9 DSU). Recommendations and rulings under the WTO dispute settlement system cannot add to or diminish the rights and obligations provided in the WTO agreements (Articles 3.2 and 19.2 DSU).

The Central Concept of Nullification or Impairment

The concept of nullification or impairment of benefits is central to dispute settlement in the WTO (Article XXIII:1 GATT 1994). In case of violation of an agreement, nullification or impairment is presumed to exist. This means that there is normally a presumption that a breach of the rules has an adverse impact on other WTO Members. In such a case, it will be up to the Member against which the complaint is brought to rebut the charge (Article 3.8 DSU). In the absence of a

violation by another WTO Member, i.e. in a situation of "non-violation nullification or impairment" (Article XXIII:1(b) GATT 1994) or as a result of any other situation (Article XXIII:1(c) GATT 1994), no presumption applies and the complaining party bears the burden of proof of establishing the existence of a nullification or impairment. The DSU develops the rules applicable to situations where either of the two latter situations are invoked (Article 26 DSU). An example of a report based on a finding of "non-violation nullification or impairment" is the report of the panel on EEC - Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, complaint by the United States (BISD 37S/86), which dealt with a US claim that the EC had impaired its zero tariff binding on oilseeds by providing domestic subsidies to the EC oilseeds industry.

With regard to Annex 1B (trade in services), the failure by any Member to carry out its obligations or specific commitments under GATS gives another Member the right to have recourse to the DSU (Article XXIII:1 GATS). Nullification or impairment of a benefit, which could be reasonably expected to accrue to a Member under a specific commitment, can be alleged in the absence of a conflict with the provisions of GATS (Article XXIII: 3 GATS).

Finally, the provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the DSU are applicable to consultations and dispute settlement under the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS"). However, during a period of 5 years from the entry into force of the WTO Agreement, Members do not have the right to allege nullification or impairment in cases where a measure adopted by a Member does not conflict with that Member's obligations under the WTO Agreement (Article XXIII:1(b) GATT 1994) or in any other situation except a violation of a WTO Agreement (Article XXIII:1(c) GATT 1994) (see: Article 64 TRIPS).

Who Can Participate?

Only WTO Members can take part in dispute settlement under the WTO. WTO dispute settlement is not open to WTO observers, other international organizations, non-governmental organizations, local governments or private persons.



The WTO dispute settlement mechanism provides for three main ways of resolving disputes:

- (i) bilateral consultations;
- (ii) good offices, conciliation and mediation; and
- (iii) adjudication, including arbitration.

With the exception of arbitration, adjudication cannot be requested until consultations have taken place or unsuccessful attempts to consult have been made. The DSU contains rules and procedures to be followed by WTO Members for both.

The DSU favours solutions mutually acceptable to the parties to the dispute,

provided that they are consistent with the WTO Agreements (Article 3.7 DSU). Mutually agreed solutions to matters formally raised under the consultation and dispute settlement provisions of the covered agreements must be notified to the DSB and the relevant Councils and Committees, where any Member may raise any point relating thereto (Article 3.6 DSU). For an example of notified solution, see: Korea - Measures Affecting the Shelf-Life of Products, complaint by the United States (WT/DS5), where the parties notified a mutually acceptable solution to the DSB. consultations and adjudications.

Complaint by more than one Member

More than one Member may request the establishment of a panel related to the same matter, in which case a single panel may be established to examine these complaints (Article 9.1 DSU). In United States -Import Prohibition of certain Shrimp and Shrimp Products, complaint by India, Malaysia, Pakistan and Thailand (WT/DS58), the DSB decided to establish one single panel, despite the separate request made by India once a panel had already been established at the request of the other Members. If more than one panel is established to examine complaints related to the same subject matter, the same persons are required, to the greatest extent possible, to serve as panelists on each of the separate panels and the timetable for the cases was to be harmonized (Article 9.3 DSU). In European Communities - Measures Affecting Meat and Meat products (Hormones), for instance, the complaint of Canada (WT/DS48) and that of the United States (WT/DS26) were reviewed by two separate panels composed of the same individuals.

Who can take part in consultations?

Each Member undertakes to accord sympathetic consideration to, and afford adequate opportunity for consultation regarding, any representation made by another Member concerning measures affecting the operation of any WTO agreement (Article 4.2 DSU). Consultations have a number of functions. They allow parties to clarify the facts of the matter, thus dispelling misunderstandings as to the actual nature of the measure at issue. They may allow parties to find a mutually satisfactory solution, and, if no solution is found at that stage, permit them to take stock of the issues, which were not solved through consultations.

Under certain conditions, parties, which did not request consultations, in the first place may request to be joined in consultations. If a member other than the consulting Members considers that it has a substantial trade interest in consultations being held pursuant to Articles XXII:1 of GATT 1994 or XXII:1 of GATS, or the corresponding provisions of the other covered agreements, it may notify the consulting Members and the DSB of its desire to be joined in the consultations. Such a notification has to be submitted within 10 days after the circulation of the original request for consultations. If the consulting member to whom the request for consultation was addressed agrees that the claim of substantial interest is well founded, the requesting Member joins the consultations. The DSB must be informed accordingly. If the request is not accepted, the Member concerned is free to request separate consultations (Article 4.11 DSU). Requests to be joined in consultations are found in almost all cases submitted to the DSB.

Third parties to the proceedings before the panel and the Appellate Body

Complainant and respondent Members are the main parties to the disputes.

Third parties also have an opportunity to be heard by panels and to make written submissions, provided they have a substantial interest in the matter before the panel and they have notified their interest to the DSB (Article 10.2 DSU). If a third party considers that a measure already the subject of a panel nullifies or impairs benefits accruing to it under any covered agreement, it may make its own request for the establishment of a panel. The original panel will be assigned the new dispute wherever possible (Article 10.4 DSU).

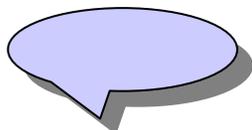
Without a means of settling disputes, the rules-based system would be worthless because the rules could not be enforced. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. The system is based on clearly defined rules, with timetables for completing a case.

First rulings are made by a panel and endorsed (or rejected) by the WTO's full membership. Appeals based on points of law are possible.

However, the point is not to make rulings. The priority is to settle disputes, through consultations if possible. By July 2000, 32 out of 203 cases had been settled "out of court", without going through the full panel process.

How long to settle a dispute?

These approximate periods for each stage of a dispute settlement procedure are target figures - the agreement is flexible. In addition, the countries can settle their dispute themselves at any stage. Totals are also approximate.



60 days	<i>Consultations, mediation, etc.</i>
45 days	<i>Panel set up and panelists appointment</i>
6 months	<i>Final panel report to parties</i>
3 weeks	<i>Final panel report to WTO members</i>
60 days	<i>Dispute Settlement Body adopts appeals report (if no appeal)</i>
<i>Total = 1 year</i>	<i>(without appeal)</i>
60-90 days	<i>Appeal report</i>
30 days	<i>Dispute Settlement Body adopts appeals report</i>
<i>Total = 1 year 3 months</i>	<i>(With appeal)</i>

DISPUTE SETTLEMENT PROCEDURE

The operation of the WTO dispute settlement process involves the Dispute Settlement Body, the panels and the Appellate body, the parties and the WTO Secretariat. The General Council discharges its responsibilities with respect to dispute settlement through the Dispute Settlement Body, which is composed, of

representatives of all WTO members. Panels and the Appellate Body are the entities in charge of adjudicating disputes. The former are composed of experts selected on an *ad hoc* basis. The latter is a permanent group of seven experts in trade issues and trade law in charge of reviewing the legal aspects of the reports issued by panels.

Settling disputes is the responsibility of the Dispute Settlement Body (the General Council in another guise). The Dispute Settlement Body has the sole authority to establish "panels" of experts to consider the case, and to accept or reject the panels' findings or the results of an appeal. It monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling.

The Dispute Settlement Body (the "DSB") is responsible for administering the DSU. The DSB has the authority to establish panels, adopt panel and Appellate Body reports, maintain surveillance of implementation of rulings or recommendations of panels or of the Appellate Body and authorize suspension of concessions or other obligations under the covered agreements (Article 2.1 DSU).

The general rule is for the DSB to take decisions by consensus, as is the case for all decision-making in the WTO. It is deemed to have decided by consensus on a matter submitted for its consideration, if no WTO Member, present at the meeting of the DSB when the decision is taken, formally objects to the proposed decisions (footnote 1 to Article 2.4 DSU). However, a radically different procedure is followed in decision-making at four key stages in the dispute settlement process: establishment of panel, adoption of panel and Appellate Body reports and authorization for retaliation. At these stages the decision is taken to accept the request or adopt the report unless there is a consensus against it. The rule of negative consensus on these matters makes decision-making quasi-automatic. This contrasts sharply with the situation that prevailed under GATT 1947, when reports of panels could only be adopted on the basis of consensus. Unlike under GATT 1947, the DSU provides no opportunity for blockage in decision-making. The DSB meets as often as necessary to adhere to the time frames provided for in the DSU.

All Members are entitled to participate in meetings of the DSB. However, when the DSB administers the dispute settlement provisions of a Plurilateral Trade Agreement, only Members that are parties to that Agreement may participate in decisions or actions taken by the DSB with respect to disputes under the Agreement (Articles 2.1 DSU).

In a dispute settlement procedure involving a least-developed country Member, when a satisfactory solution has not been found during consultations, the Chairman of the DSB must, upon request by a least-developed country Member, offer his or her good offices, conciliation or mediation with a view to assisting the parties to settle the dispute, before a request for a panel is made (Article 24.2 DSU). In providing such assistance the Chairman of the DSB may consult any source which he or she deems appropriate

First stage: Consultation (up to 60 days). Before taking any other actions the countries in dispute have to talk to each other to see if they can settle their differences by themselves. If that fails, they can also ask the WTO director-general to mediate or try to help in any other way.

In the DSU, Members affirm their resolve to strengthen and improve the effectiveness of the consultation procedures (Article 4.1 DSU). As part of this resolve, they undertake to accord sympathetic consideration to, and afford adequate opportunity for, consultations regarding any representation made by another Member concerning measures affecting the operation of any WTO Agreement taken within the territory of the former (Article 4.2 DSU and footnote 3 to Article 4.3 DSU). Requests for consultations must be notified to the DSB (Article 4.4 DSU) but the consultations themselves remain confidential (Article 4.6 DSU). Mutually agreed solutions to matters formally raised under the consultation provisions of the covered agreements must be notified to the DSB and the relevant Councils and Committees, where any Member may raise any point relating to them (Article 3.6 DSU).

There are rules for normal consultations and for consultations on urgent matters. Before initiating consultations, a Member must exercise its judgement as to whether such an action would be fruitful, the aim of the dispute settlement mechanism being to secure a positive solution to the dispute (Article 3.7 DSU). The Member to which a normal request for consultation is made is required, unless otherwise mutually agreed, to reply to the request within 10 days after the date of its receipt and to enter into consultations in good faith within a period of no more than 30 days after the date of receipt, with a view to reaching a mutually satisfactory solution. If the requested Member does not do so, the Member that requested consultations may proceed directly to request the establishment of a panel (Article 4.3 DSU).

In cases of urgency, including those, which concern perishable goods, Members must enter into consultations within a period of no more than 10 days after the date of receipt of the request. If the consultations fail to settle the dispute within a period of 20 days after the date of receipt of the request, the complaining party may request the establishment of a panel (Article 4.8 DSU).

Under the DSU, a third party requesting to join consultations must have a substantial trade interest. Moreover, such a third party may participate at the consultation stage only if consultations were requested pursuant to Article XXII:1 GATT 1994, Article XXII:1 GATS, or corresponding provisions of the covered agreements, and if the Member to which the request is made agrees that the third party has a substantial trade interest.

Second stage: The panel (up to 45 days for a panel to be appointed, plus 6 months for the panel to conclude). If consultations fail, the complaining country can ask for a panel to be appointed. The country "in the dock" can block the creation of a panel once, but when the Dispute Settlement Body meets for a second time, the appointment can no longer be blocked (unless there is a consensus against appointing the panel).

If the consultations have failed to settle a dispute within 60 days after the date of receipt of the request for consultations, the complaining party may request the establishment of a panel. An earlier request for a panel is permitted if the consulting parties jointly consider that consultations have failed to settle the dispute (Article 4.7 DSU). A request for the establishment of a panel must be made in writing. It must indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly (Article 6.2 DSU).

The panel will be established at the latest at the DSB meeting following that at which the request first appears as an item on the agenda of the DSB, unless the complaining party no longer requests it or the DSB decides by consensus at that meeting not to establish a panel (Article 6.1 DSU). If the complaining party so requests, a special meeting of the DSB must be convened for the purpose of establishing the panel within 15 days of the request, provided that at least 10 days' advance notice is given.

A panel is considered to be properly constituted after the terms of reference (Article 7 DSU) have been agreed upon and the panelists have been selected (Article 8 DSU). Panels usually have standard terms of reference, unless the parties to the dispute agree otherwise within 20 days from the establishment of the panel (Article 7.1 DSU). In *Brazil - Measures Affecting Desiccated Coconut*, complaint by the Philippines (WT/DS22) special terms of reference were agreed by the parties. The practice of the WTO has been to refer, in the standard terms of reference, to the document in which the complaining party(ies) has(ve) requested the establishment of the panel, and to leave it to the panel to decide on any jurisdictional issue as well as whether sufficient consultations took place on the measure for which a panel is requested. If other than standard terms of reference are agreed upon, any Member may raise any point relating thereto in the DSB (Article 7.3 DSU). This provision is indicative of the multilateral character of the DSU dispute settlement process.

Officially, the panel is helping the Dispute Settlement Body make rulings or recommendations. But because the panel's report can only be rejected by consensus in the Dispute Settlement Body, its conclusions are difficult to overturn. The panel's findings have to be based on the agreements cited.

The panel's final report should normally be given to the parties to the dispute within six months. In cases of urgency, including those concerning perishable goods, the deadline is shortened to three months.

Panels are like tribunals. But unlike in a normal tribunal, the panelists are usually chosen in consultation with the countries in dispute. Only if the two sides cannot agree does the WTO director-general appoint them. This only happens rarely.

Panels consist of three (occasionally five) experts from different countries who examine the evidence and decide who is right and who is wrong. The panel's report is passed to the Dispute Settlement Body, which can only reject the report by consensus.

Panelists for each case can be chosen from a permanent list of well-qualified candidates, or from elsewhere. They serve in their individual capacities. They cannot receive instructions from any government.

Task of panels: Review the facts and arguments submitted by the parties to a particular dispute

Where the Members concerned cannot find a mutually agreed solution through consultations, the DSB must, at the request of a party to the dispute, establish a panel of three to five independent trade experts appointed on an *ad hoc* basis. The panel must review the factual and legal aspects of the case and submit a report to the DSB. It must make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability, of and the

conformity of challenged measures with, the relevant covered agreements, and make such findings as will assist the DSB in making its rulings or recommendations (Article 11 DSU).

Composition of panels: who can be called to serve on a panel?

The composition of the panel (Article 8 DSU) takes place once the panel has been established by the DSB. Potential candidates must meet certain requirements in terms of qualifications. Panels are composed of three panelists unless the parties to the dispute agree, within 10 days from the establishment of the panel, to a panel composed of five panelists (Article 8.5 DSU). The Secretariat proposes nominations for the panel to the parties to the dispute. The parties to the dispute must not oppose nominations except for compelling reasons (Article 8.6 DSU). An indicative list has been established, containing the names of governmental and non-governmental persons, from which panelists may be drawn (Article 8.4 DSU). Citizens of a party or a third party to a dispute may not serve as panelists, without the agreement of the parties (Article 8.3 DSU). When a dispute is between a developing country Member and a developed country Member the panel shall, if the developing country Member so requests, include at least one panelist from a developing country Member (Article 8.10 DSU). Panels are to be composed of well-qualified governmental and/or non-governmental individuals, including persons who, pursuant to Article 8.1 DSU:

- have served on or presented a case to a panel; or
- have served as a representative of a Member or of a contracting party to GATT 1947 or as a representative to the Council or Committee to any covered agreement or its predecessor (Kennedy or Tokyo Round) agreement; or
- have served in the Secretariat; or
- have taught or published on international trade law or policy; or
- have served as a senior trade policy official of a WTO Member.

Panelist selection process

Selection of panelists is made with a view to ensuring the independence of panel members, a sufficiently diverse background and a wide spectrum of experience (Article 8.2 DSU). Citizens of WTO Members whose governments are parties to the dispute or third parties as defined in the DSU may not serve on a panel concerned with that dispute, unless the parties to the dispute agree otherwise (Article 8.3 DSU). Panelists may be selected from an indicative list maintained by the Secretariat. WTO Members may periodically suggest names to be added to the list upon approval by the DSB (Article 8.4 DSU). When a dispute is between a developing country Member and a developed country Member, the developing country Member may request that the panel include at least one panelist from a developing country Member (Article 8.10 DSU).

Where more than one Member requests the establishment of a panel related to the same matter, the DSB should, whenever feasible, establish a single panel to examine these complaints taking into account the rights of all Members concerned (Article 9.1 DSU) - see: Shrimp United States - Import Prohibition of certain Shrimp and Shrimp Products, complaint by India, Malaysia, Pakistan and Thailand

(WT/DS5(8)). If more than one panel is established, to the greatest extent possible the same persons are required to serve as panelists on each of the separate panels (Article 9.3 DSU).

Appointment of panelists

Panelists are proposed by the Secretariat to the parties to the dispute, who may oppose nominations only for compelling reasons (Article 8.6 DSU). Panelists are normally appointed by agreement of the parties. Where there is no agreement within 20 days after the date of establishment of the panel, the composition of the panel will, at the request of either party, be determined by the Director-General of the WTO, in consultation with the Chairman of the DSB and the Chairman of the relevant Council or Committee (Article 8.7 DSU). Once appointed, panelists serve in their individual capacities, not as government representatives or as representatives of any organization (Article 8.9 DSU). They are also subject to the Rules of Conduct for the Understanding on Rules and Procedures Governing the Settlement of Disputes.

Panels have the right to seek information and technical advice from any individuals or bodies, which they deem appropriate. They may seek information from any relevant source (Article 13.1 DSU). However, before seeking information and technical advice from any individual or body within the jurisdiction of a Member, the panel must inform that Member.

Consultation of experts

Panels may consult experts to obtain their opinion on certain aspects of the matter before them. Provisions in the covered agreements pursuant to which panels may have the possibility or the obligation to seek opinions of experts are the following:

- Article 11.2 Agreement on the Application of Sanitary and Phytosanitary Measures;
- Article 14.2 and 3, Annex 2 Agreement on Technical Barriers to Trade;
- Article 19.3 and 4, Annex 2 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994;
- Articles 4.5, 24.3 Agreement on Subsidies and Countervailing Measures (the "SCM Agreement").

CIRCUMSTANCES AND NATURE OF CONSULTATIONS OR EXPERT REVIEW GROUPS

With respect to a factual issue concerning a scientific or other technical matter raised by a party to a dispute, panels may request an advisory report in writing from an expert review group (Article 13.2 DSU). Rules for the establishment of expert review groups and their procedures are contained in Appendix 4 DSU. Expert review groups are under the panels' authority and report to the panel. The panel decides their terms of reference and detailed working procedures. Final reports of expert review groups are issued to the parties to the dispute when submitted to the panel. Reports have only an advisory value.

Composition of Expert Review Groups

Participation in expert review groups is restricted to persons of professional standing and experience in the field in question. Citizens of parties to the dispute

cannot serve on an expert review group without the joint agreement of the parties to the dispute, except in exceptional circumstances when the panel considers that the need for specialized scientific expertise cannot be fulfilled otherwise. Government officials of parties to the dispute may not serve on an expert review group. Members of expert review groups serve in their individual capacities and not as government representatives, nor as representatives of any organization. Governments or organizations therefore must not give them instructions with regard to matters before an expert review group.

Panel procedures are primarily set out in Article 12 and Appendix 3 DSU. During a first "organizational" meeting, the panel, guided by the suggested timetable in Appendix 3 DSU, determines its calendar of work in consultation with the parties (Article 12.3 DSU).

The agreement describes in some detail how the panels are to work. The main stages are:

Before the first hearing: each side in the dispute presents its case in writing to the panel. Parties exchange written submissions, and the panel convenes at least two hearings where parties are entitled to present their views orally and the panel may ask clarifications and questions. Panels have the right to ask written questions. Third parties with a substantial interest in the matter before the panel, and who have notified their interest to the DSB, are to be granted an opportunity to be heard by the panel and make written submissions (Article 10.2 DSU).

Experts: if one side raises scientific or other technical matters, the panel may consult experts or appoint an expert review group to prepare an advisory report.

First draft: the panel submits the descriptive (factual and argument) sections of its report to the two sides, giving them two weeks to comment. This report does not include findings and conclusions.

Interim report: The panel then submits an interim report, including its findings and conclusions, to the two sides, giving them one week to ask for a review. Two to four weeks after the receipt of comments on the descriptive part, the panel issues its interim report containing the revised descriptive part and the findings of the report. Parties are again invited to make comments and may request an interim review meeting of the panel to further argue specific points raised with respect to the interim report. This is the interim review stage (Article 15 DSU). The final report must contain a reference to all the arguments raised by the parties during the interim review stage (Article 15.3 DSU).

Review: The period of review must not exceed two weeks. During that time, the panel may hold additional meetings with the two sides.

Final report: A final report is submitted to the two sides and three weeks later, it is circulated to all WTO members. If the panel decides that the disputed trade measure does break a WTO agreement or an obligation, it recommends that the measure be made to conform to WTO rules. The panel may suggest how this could be done.

Panel reports have two main parts: the "descriptive part" and the "findings". The descriptive part is usually composed of an introduction, the factual aspects, the

claims of the parties (also sometimes called "Findings Requested"), the submission(s) of the third party or parties, the main arguments of the parties and the specific arguments raised during the interim review stage. The "findings" part is composed of the findings as such and the conclusions and recommendations.

The report becomes a ruling: The report becomes the Dispute Settlement Body's ruling or recommendation within 60 days unless a consensus rejects it. Both sides can appeal the report (and in some cases both sides do).

As a general rule, panels are required to issue the final report to the parties within six months from the date when the composition and the terms of reference of the panel have been agreed upon. In cases of urgency, the panel is to aim to issue its report to the parties to the dispute within three months from its constitution (Article 12.8 DSU). When the panel considers that it cannot issue its report within six months or three months in case of urgency, it must inform the DSB in writing of the reasons for the delay and provide an estimate of the period within which it will issue its report. In any case, the examination is to be completed within nine months of the establishment of the panel (Article 12.9 DSU). Panels may suspend their work at the request of the complaining party for a period not exceeding 12 months. Beyond that period, the authority for the establishment of the panel lapses (Article 12.12 DSU).

Panel deliberations are confidential. Reports of panels are drafted without the presence of the parties to the dispute, in the light of the information provided and the statements made. The opinions expressed in the panel report by individual panelists are anonymous (Article 14 DSU). Before the entry into force of the WTO, a few panel reports included dissenting opinions - see: e.g. EEC - Programme of Minimum Import Prices, Licence and Surety Deposits for Certain Processed Fruits and Vegetables (BISD 25S/68).

Appeals

Either side can appeal a panel's ruling. Sometimes both sides do so. Appeals have to be based on points of law such as legal interpretation - they cannot reexamine existing evidence or examine new evidence.

Three members of a permanent seven-member Appellate Body set up by the Dispute Settlement Body and broadly representing the range of WTO memberships hear each appeal. Members of the Appellate Body have four-year terms. They have to be individuals with recognized standing in the field of law and international trade, not affiliated with any government.

The appeal can uphold, modify or reverse the panel's legal findings and conclusions. Normally appeals should not last more than 60 days, with an absolute maximum of 90 days.

The Dispute Settlement Body has to accept or reject the appeals report within 30 days and rejection is only possible by consensus.

Appeals are limited to issues of law covered in the panel report and legal interpretations developed by the panel (Article 17.6 DSU). The Appellate Body must address, but also limit its review to, each of the issues of law covered by the panel report and the legal interpretations developed by the panel which were appealed

during the appellate proceeding (Article 17.6 and 12 DSU). The Appellate Body may uphold, modify or reverse the legal findings and conclusions of the panel (Article 17.13 DSU).

TASK OF THE APPELLATE BODY: REVIEW ON APPEAL THE ISSUES OF LAW ADDRESSED BY PANELS

If a party files an appeal against the report of the panel, the Appellate Body shall review the issues of law addressed by the panel and confirm or modify its findings (Article 17.6 DSU). In *Brazil - Measures Affecting Desiccated Coconut*, complaint by the Philippines (WT/DS22), the Appellate Body upheld both the findings and legal interpretations of the panel. In contrast, in *Japan - Taxes on Alcoholic Beverages*, complaint by the European Communities (WT/DS8), Canada (WT/DS10) and the United States (WT/DS11), the Appellate Body affirmed the panel's conclusions but pointed out several areas where it considered the panel had erred in its legal.

Composition of the Appellate Body

Persons serving on the Appellate Body serve on divisions in rotation (Article 17.1 DSU). The DSB is responsible for appointing Appellate Body members (Article 17.2 DSU). The Appellate Body must be composed of persons of recognized authority, with demonstrated experience in law, international trade and the subject matter of the WTO Agreements generally. The Appellate Body membership must be broadly representative of membership of the WTO. Each of the seven experts on the Appellate Body is appointed for a four-year term, which is renewable once. Three of them (called a Division) serve on any one case.

Operation of the Appellate Body

The Appellate Body determines its own rules of procedure. The proceedings of the Appellate Body are confidential. Reports of the Appellate Body are drafted without the presence of the parties to the dispute and in the light of the information provided and the statements made (Article 17.10 DSU). The opinions expressed in the Appellate Body report by individuals serving on the Appellate Body are anonymous (Article 17.11 DSU). To date, there have not been any dissenting opinions and the Rules of Procedure of the Appellate Body envisage that members of the Appellate Body shall make every effort to take their decisions by consensus. Where, nevertheless, a decision cannot be arrived at by consensus, the matter at issue has to be decided by majority vote (Rule 3.2 Working Procedures for Appellate Review).

An Appellate Body report has a somewhat different structure: it is generally composed of an introduction including some factual aspects, a part on the issues raised in the appeal, and the discussion of these issues, and the findings and conclusions and recommendations.

Where a panel or the Appellate Body concludes that a measure is inconsistent with a covered agreement, it must recommend that the Member concerned bring the measure into conformity with that agreement. In addition to its recommendations, the panel or Appellate Body may suggest ways in which the Member concerned could implement the recommendations (Article 19.1 DSU).

Adoption of Appellate Body Reports

An Appellate Body report must be adopted by the DSB and unconditionally accepted by the parties to the dispute unless the DSB decides by consensus not to adopt the Appellate Body report within 30 days following its circulation to Members. This adoption procedure is without prejudice to the right of Members to express their views on an Appellate Body report. If a meeting of the DSB is not scheduled during this period, such a meeting must be held to discuss and adopt the report (Article 17.14 DSU and footnote 8 to Article 17.14 DSU). A practice has developed whereby the Appellate Body report and the related panel report, as modified by the Appellate Body report, are adopted by the DSB at the same time.

Arbitration as an alternative to dispute resolution through panel and Appellate Body procedure

Arbitration may be resorted to by parties to a dispute, through mutual agreement (Article 25 DSU). The DSU does not contain detailed procedures regarding resort to arbitration, selection and operation of arbitrators or arbitrating entities under Article 25 DSU. Parties to the dispute are free to apply the rules and procedures they deem appropriate through mutual agreement. Articles 21 and 22 DSU apply *mutatis mutandis* to arbitral awards (Article 25.4 DSU).

Arbitration in the Implementation of Reports

Arbitration may also be used to establish the "reasonable period of time" for implementation of DSB recommendations and rulings (Article 21.3(c) DSU) and may be resorted to by a party subject to suspension of concessions or other obligations if it objects to the level of suspension proposed or claims that the principles and procedures to be followed by a complaining party suspending concessions or other obligations were not respected by that party (Article 22.6 DSU). In Japan - Taxes on Alcoholic Beverages, complaint by the European Communities (WT/DS8), Canada (WT/DS10) and the United States (WT/DS11), the United States applied for binding arbitration to determine the reasonable period of time for implementation by Japan of the recommendations of the Appellate Body. The Arbitrator found the reasonable period for implementation to be 15 months.

SURVEILLANCE AND IMPLEMENTATION OF REPORTS

In the WTO, there is no independent policing body responsible for enforcing the recommendations of panels and the Appellate Body. The DSB states that prompt compliance with the recommendations or rulings of the DSB is essential in order to ensure the effective resolution of disputes (Article 21.1 DSU). The DSB, composed of all WTO Members, supervises the implementation of panel and Appellate Body reports.

The surveillance and implementation procedures require that: at a DSB meeting held within 30 days after the adoption of the report(s), the losing party must state its intentions in respect of implementation of the recommendations adopted (Article 21.3 DSU). If it is impracticable to comply immediately, the party will be granted a reasonable period of time. This reasonable period of time:

- (i) may be the period of time proposed by the Member concerned with the approval of the DSB (Article 21.3(a) DSU); or

- (ii) may be agreed upon by the parties within 45 days after the adoption of the report (Article 21.3(b) DSU); or
- (iii) may be determined by arbitration within 90 days after the adoption of the report (Article 21.3(c) DSU).

When the reasonable period of time is arbitrated, a guideline for the arbitrator is that the reasonable period of time to implement panel or Appellate Body recommendations should not exceed 15 months from the date of adoption of a panel or Appellate Body report (In Japan - Taxes on Alcoholic Beverages (WT/DS11), the arbitrator found 15 months to be the reasonable period for implementation of the recommendations). However, that time may be shorter or longer, depending upon the particular circumstances (Article 21.3(c) DSU).

The period from the date of establishment of a panel by the DSB until the date of determination of the reasonable period of time is also not to exceed 15 months unless the parties to the dispute agree otherwise. Where either the panel or the Appellate Body has acted to extend the period of time for their consideration of a case, the additional time taken shall be added to the 15-month period; however, unless the parties to the dispute agree that there are exceptional circumstances, the total time is not to exceed 18 months (Article 21.4 DSU).

If there is disagreement as to the consistency with the WTO Agreement of measures taken to comply with DSB recommendations, a party may have recourse to dispute settlement procedures, referring the matter to the initial panel wherever possible for expedited adjudication (Article 21.5 DSU).

Surveillance by the DSB is an important feature of the dispute settlement mechanism of the WTO. Good-faith compliance by the Member, surveillance and authorization of retaliatory measures are the only instruments available to the WTO to secure the implementation of panel and Appellate Body recommendations.

The DSB is required to keep under surveillance the implementation of adopted recommendations or rulings. Any member may raise the issue of implementation of the recommendations or rulings at the DSB at any time following their adoption. Unless the DSB decides otherwise, the issue of implementation of the recommendations or rulings shall be placed on the agenda of the DSB meeting after six months following the date of establishment of the reasonable period of time and shall remain on the DSB's agenda until the issue is resolved. At least 10 days before each such DSB meeting, the Member concerned is required to provide the DSB with a status report in writing of its progress in the implementation of the recommendations or rulings (Article 21.6 DSU). The DSB must continue to keep under surveillance the implementation of adopted recommendations or rulings, including those cases where compensation has been provided or concessions or other obligations have been suspended but the recommendations to bring a measure into conformity with the covered agreements have not been implemented (Article 22.8 DSU).

Non-compliance

In cases of non-compliance parties may agree to compensation. In the absence

of such agreement the winning Member may retaliate but only after obtaining the prior authorization of the DSB.

If the WTO Member concerned fails within the reasonable period of time to bring the measure found to be inconsistent with the covered agreement into compliance in accordance with the recommendations, that Member must, if so requested, enter into negotiations with a view to agreeing on mutually acceptable compensation (Article 22.2 DSU).

CONDITIONS FOR SUSPENSION OF CONCESSIONS OR OTHER OBLIGATIONS (RETALIATION)

Authorization for suspension of concessions and other obligations (retaliation) may be sought from the DSB by the Member concerned if no satisfactory compensation has been agreed within 20 days after the date of expiry of the reasonable period of time. The DSB is required to grant such authorization within 30 days of the expiry of the reasonable period of time unless it decides by consensus to reject the request.

The DSU imposes certain limitations with regard to the areas to which the retaliatory action should relate. For this purpose the multilateral trade agreements are grouped as three separate agreements viz. GATT 1994 (together with other multilateral trade agreements on trade in goods), the GATS and the TRIPs Agreement. Within these agreements, sectors are defined: with respect to goods, all goods are deemed as belonging to the same sector, while different sectors are identified within services and intellectual property respectively. As a general principle, the complaining party should first seek to suspend concessions or other obligations with respect to the same sector as that in which nullification or impairment has been found. If it is not practicable or effective to do so in the same sector, the suspension of concessions or other obligations may be made under the same agreement. If even that is not practicable and the circumstances are serious enough, the complaining party may seek to suspend concessions or obligations under another agreement.

The DSU provides that compensation or retaliation are only temporary measures available in the event that the recommendations and rulings are not implemented within a reasonable period of time. The full implementation of the recommendation to bring a measure into conformity with the covered agreements remains the preferred outcome. The matter is retained on the agenda of the DSB until the issue is resolved. However, in the case of a non-violation complaint, there is no obligation to withdraw the measure found to be nullifying or impairing the benefit under, or impeding the objections of the relevant covered agreements. In such cases the parties to the dispute have to make mutually satisfactory adjustments and compensation may be a part of such adjustment.

The level of suspension of concessions or other obligations authorized by the DSB shall be equivalent to the level of nullification or impairment (Article 22.4 DSU). In case of disagreement regarding either the equivalence of the level of nullification to the level of retaliation or the principles of cross-retaliation, arbitration may be requested (Article 22.5, 6 and 7 DSU). The original panel shall carry out such arbitration, if members are available, or by an arbitrator appointed by the Director-

General and shall be completed within 60 days after the date of expiry of the reasonable period of time. Concessions or other obligations shall not be suspended during the course of the arbitration (Article 22.6 DSU).

The arbitrator shall not examine the nature of the concessions or other obligations to be suspended but shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the covered agreement. However, if the matter referred to arbitration includes a claim that the principles and procedures for cross-retaliation have not been followed, the arbitrator is required, upon request, to grant authorization to suspend concessions or other obligations where the request is consistent with the decision of the arbitrator, unless the DSB decides by consensus to reject the request (Article 22.7 DSU).

ROLE OF THE DIRECTOR-GENERAL IN DSU

The Director-General of the WTO may, acting in an ex officio capacity, offer good offices, conciliation or mediation with a view to assisting Members to settle a dispute (Article 5.6 DSU). Such an offer may normally be made during the consultation period, but good offices, conciliation or mediation may, with the agreement of the parties to the dispute, continue while the panel process proceeds (Article 5.5 DSU).

In a dispute settlement procedure involving a least-developed country Member, when a satisfactory solution has not been found during consultations, the Director-General will, upon request by a least-developed country Member, offer his or her good offices, conciliation or mediation in order to help the parties to the dispute, before a request for a panel is made (Article 24.2 DSU). In providing such help, the Director-General may consult any source which he or she considers appropriate. For an example under GATT 1947, see: Japan - Measures Affecting the World Market for Copper Ores and Concentrates - Good Offices Report by the Director-General (BISD 36S/199).

The Director-General may also be requested, in certain circumstances, to appoint panel members. This is the case where, within 20 days after the date of the establishment of a panel, there has been no agreement among the parties on the composition of the panel (Article 8.7 DSU). The Director-General can act only at the request of either party in the dispute. The Director-General must determine the composition of the panel in consultation with the Chairman of the DSB and the Chairmen of the relevant Councils or Committees, after consulting the parties to the dispute. He or she must appoint the panelists whom he or she considers most appropriate in accordance with the DSU and any other special or additional rules or procedures of the covered agreement(s) concerned in the dispute.

The Director-General may appoint an arbitrator in cases where it is necessary to determine the reasonable period of time for implementation (Articles 21.3(c) DSU) or where a suspension of concessions or other obligations has been authorized by the DSB under Article 22 DSU and the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures to be followed when considering what concessions or other obligations to suspend were not respected (Article 22.6 DSU). The appointment of an arbitrator under Article 22 by

the Director-General is an alternative to arbitration by the original panel, which shall carry it out if its members are available. The Director-General may appoint as arbitrator an individual or a group.

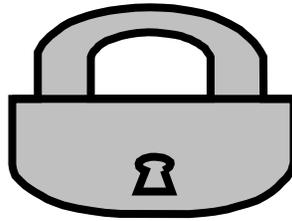
The Secretariat is to provide additional legal advice and assistance in respect of dispute settlement to developing country Members. To this end, the Secretariat is required to make available a qualified legal expert from the WTO technical cooperation services to any developing country member which so requests. The appointed expert will assist the developing country Member. However, the expert must do so in such a way that the continued impartiality of the Secretariat is respected (Article 27.2 DSU).

LESSON ROUND UP



- The Dispute Settlement Understanding (DSU) is often seen as one of the most important achievements in the World Trade Organization (WTO) Agreement. Renato Ruggiero, former WTO director general, called the dispute settlement procedure the WTO's most individual contribution to the stability of the global economy.
- The WTO dispute settlement mechanism is a rule-oriented system where recommendations and rulings must aim at achieving a satisfactory settlement in accordance with the rights and obligations of the Members under the WTO Agreement.
- Only WTO Members can take part in dispute settlement under the WTO. WTO dispute settlement is not open to WTO observers, other international organizations, non-governmental organizations, local governments or private persons.
- The WTO dispute settlement mechanism provides for three main ways of resolving disputes: (i) bilateral consultations; (ii) good offices, conciliation and mediation; and (iii) adjudication, including arbitration.
- Settling disputes is the responsibility of the Dispute Settlement Body. The Dispute Settlement Body has the sole authority to establish "panels" of experts to consider the case, and to accept or reject the panels' findings or the results of an appeal. It monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling.
- The Director-General of the WTO may, acting in an ex officio capacity, offer good offices, conciliation or mediation with a view to assisting Members to settle a dispute. Such an offer may normally be made during the consultation period, but good offices, conciliation or mediation may, with the agreement of the parties to the dispute, continue while the panel process proceeds.

SELF TEST QUESTIONS



1. What is a 'Rule based system'. How does WTO dispute settlement mechanism qualify as one.
2. Who can participate in the dispute settlement mechanism under the WTO?
3. Write a note on Appellate Body set up by the Dispute Settlement Body.
4. Show how the dispute settlement mechanism under WTO is superior to that of GATT.
5. "The Concept of nullification or impairment of benefits is central to dispute settlement under WTO". Discuss.

PROFESSIONAL PROGRAMME
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

PP-SMA&IT/2011

TEST PAPERS

This Test Paper set contains Five Test Papers i.e. Test Paper 1/2011, 2/2011 3/2011, 4/2011, and 5/2011. The maximum time allowed to attempt the Test Paper is 3 hours.

Students are advised to attempt atleast **one Test Paper from Test Papers 3/2011, 4/2011 and 5/2011 i.e. either Test Paper 3/2011 or Test Paper 4/2011 or Test Paper 5/2011** and send the response sheet for evaluation to make him/her eligible for Coaching Completion Certificate. However, students may, if they so desire, send more response sheets including Test Paper 1/2011 and 2/2011 for evaluation.

While writing answers, students should take care not to copy verbatim from the study material, text books or other publications. Instances of deliberate copying from any source will be viewed very seriously.

W A R N I N G

It is brought to the notice of all the students pursuing Company Secretaryship Course that they should follow strict discipline while writing response sheets to the Test Papers appended herewith in this Study Material. Any attempt of unfair means by students in completing the postal coaching by way of submitting response sheets in different handwritings or by way of copying from the study material/suggested answers supplied by the Institute or from the answers of the students who have already completed the course successfully, etc., will be viewed seriously by the Institute. Students are, therefore, advised to write their response sheets in their own handwriting without copying from any original source.

Students may note that use of any malpractice while undergoing postal or oral coaching is a misconduct as per certain provisions of Company Secretaries Regulations and accordingly the registration of such students is liable to be cancelled or terminated.

PROFESSIONAL PROGRAMME
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

TEST PAPER 1/2011

PART-A

(Answer ANY TWO questions from this part)

Time allowed : 3 hours

Maximum marks : 100

1. (a) "Strategic management is the art and science of formulating, implementing and evaluating cross-functional decisions that enables an organization to achieve its objectives". Comment. *(5 marks)*
- (b) In B.C.G. matrix for what the metaphors like stars, cows and dogs are used? *(5 marks)*
- (c) Discuss the reasons underlying resistance to change. *(5 marks)*
- (d) PLC is an S-shaped curve? Do you agree? Explain. *(5 marks)*
2. Explain the following:
 - (i) McKinsey's 7-S framework
 - (ii) Stability Strategies
 - (iii) Porter's five forces model
 - (iv) Concentric diversification. *(5 marks each)*

3. Read the following case study and answer the questions given at the end:

Meredien Limited is a company engaged in the designing, manufacturing, and marketing of instruments like speed meters, oil pressure gauges, and so on, that are fitted into two and four wheelers. Their current investment in assets is around ₹ 10 crores and their last year turnover was ₹ 20 crores, just adequate enough to breakeven. The company has been witnessing over the last couple of years, a fall in their market share prices since many customers are switching over to a new range of electronic instruments from the range of mechanical instruments that have been the mainstay of Meredien Limited.

The company has received a firm offer of cooperation from a competitor who is similarly placed in respect of product range. The offer implies the following:

- (i) transfer of the manufacturing line from the competitor to Meredien Limited;
- (ii) manufacture of mechanical instruments by Meredien Limited for the competitor to the latter's specifications and brand name; and
- (iii) marketing by the competitor.

The benefits that will accrue to Meredien Limited will be better utilization of its installed capacity and appropriate financial compensation for the manufacturing effort.

The production manager of Meredien Limited has welcomed the proposal and points out that it will enable the company to make profits. The sales manager is doubtful about the same since the demand for mechanical instruments is shrinking. The Chief Executive is studying the offer.

Questions:

- (a) What is divestment strategy? Do you see it being practised in the given case? Explain. (5 Marks)
- (b) What is stability strategy? Should the company in question adopt it? (5 Marks)
- (c) What is diversification strategy? What are the implications for the company in case it is adopted? (5 Marks)
- (d) What recommendations will you give to the company in the case? (5 marks)

PART-B&C

(Answer **ANY THREE** questions from this part)

4. Distinguish between *any four* of the following:
 - (i) Strategic Alliance and Joint Venture
 - (ii) Trademark and Trade Secrets under TRIPs
 - (iii) Anti-Dumping and Countervailing Measures
 - (iv) Tariff and Non-Tariff Barriers
 - (v) National Treatment and Most Favoured Nation (5 marks each)
 5. (a) Regional Trade Agreements are barriers/hurdles for WTO Multilateral Trade Agreement. Comment. (10 marks)
 - (b) Describe the institutional structure of SAARC. (10 marks)
 6. (a) Briefly explain the objectives and functions of World Trade Organization. (10 marks)
 - (b) Briefly explain the important decisions made in Fourth Ministerial Conference held at Doha. (10 marks)
 7. (a) Enumerate the sporadic, intermittent and continuous dumping? (10 marks)
 - (b) Briefly explain the process in which WTO resolves trade dispute. (10 marks)
 8. (a) Enumerate the methods of funding for investment in an overseas Joint Venture/Wholly Owned Subsidiary. (10 marks)
 - (b) What is the place of TRIPS Agreement in the multilateral trading system? (10 marks)
-

TEST PAPER 2/2011

PART-A

(Answer **ANY TWO** questions from this part)

Time allowed : 3 hours

Maximum marks : 100

1. (a) Mention the steps which may be taken to bring in strategic change?
(5 marks)
- (b) Internal control can provide only reasonable, but not absolute assurance that the objectives are achieved. Comment. (5 marks)
- (c) Explain the expert systems with examples. (5 marks)
- (d) DSS are more targeted than MIS System. Comment. (5 marks)

2. Distinguish between the following:

- (i) Executive Information System and Decision Support System.
 - (ii) Strategy Formulation and Strategy Implementation.
 - (iii) Objective and Goals.
 - (iv) Strategic Planning and Operational Planning. (5 marks each)
3. Read the following case study and answer the questions given at the end:

MMT, a company decided to target the youngsters as primary target on the assumption that once they are lured in, it was easier to reach the whole family.

Advertising in this category was extremely crowded. Every week two-three local products in new names were launched, sometimes with similar names. To break through this clutter the company decided to bank upon humour appeal.

The Industry sources reveal that MMT spent about ₹ 50 crores on advertisement and used all possible media – print and electronic, both including the creation of its own website, funofunyoungsters.com with offers of online games, contest, freebies, shopping vouchers, etc. Free song downloading was also planned which proved very effective among teenagers. The site was advertised on all dotcom networks like Sony, Smile TV, Zee TV and other important channels were also used for its advertisement alongwith FM radio channels in about 60 cities with large hoardings at strategic places.

Analysts believe that funOfun's success story owes a lot to MMT's widespread distribution channels and aggressive advertisements. Humour appeal was a big success. The 'funOfun' was made visible by painting the Railways bogies passing across the States. It has also been successful to induce ABC's Future Group to replace Nato in their Big- Bazaar and chain of food Bazaars. MMT is paying 4% higher margin than Trepsico to Future group and other retailers.

'funOfun' is giving Trepsico a run for its money. Nato's share has already been reduced considerably. Retail tie-ups, regional flavours, regional humour appeals have helped MMT. But MMT still wants a bigger share in the market

and in foreign markets also, if possible.

Questions

- (i) What are the strengths of MMT? (5 Marks)
- (ii) What are the weaknesses of MMT for entering into the branded snacks market? (7 Marks)
- (iii) What kind of marketing strategy was formulated and implemented for funOfun? What else needs to be done by funOfun so as to enlarge its market? (8 Marks)

PART-B&C

(Answer **ANY THREE** questions from this part)

- 4. Write short notes on:
 - (i) Mercantilism
 - (ii) National treatment
 - (iii) Types of Strategic Alliance
 - (iv) Normal value. (5 marks each)
 - 5. (a) Enumerate the benefits and problems of cross cultural alliances. (10 marks)
 - (b) What are the factors to be considered while drafting a foreign collaboration agreement? (10 marks)
 - 6. (a) How is the WTO different from GATT? (10 marks)
 - (b) Discuss the institutional structure of WTO (10 marks)
 - 7. (a) Is it true that only WTO members can take part in dispute settlement? Explain various stages of settlement of disputes under WTO? (10 marks)
 - (b) What are the different kinds of subsidies available under the agreement on subsidies? (10 marks)
 - 8. (a) Discuss the procedure for Foreign Direct Investment under FDI Policy. (10 marks)
 - (b) Distinguish between plurilateral and multilateral agreements. (10 marks)
-

TEST PAPER 3/2011

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer All Questions.

PART A

(Answer **ANY TWO** questions from this part)

1. (a) What do you understand by the term 'Strategy'? Explain the four generic strategies. (10 marks)
- (b) "The impact of MIS on top level is far less than at the middle or supervisory level". In the light of the given statement, discuss and prepare a table to show its validity. (10 marks)
2. Write short notes on the following:
 - (i) Zero based budgeting (ZBB)
 - (ii) SWOT Analysis
 - (iii) Strategic change management
 - (iv) GE Matrix. (5 marks each)
3. Read the following case and answer the questions at the end:

Dr. Path Lab inherited his father's Ray's Lab in Delhi in 1995. Till 2002, he owned 5 labs in the National Capital Region (NCR). His ambition was to turn it into a National chain. The number increased to 8 in 2004 across the country, including the acquisition of Golden lab in Hyderabad. The number is likely to go to 50 within 2-3 years from 21 at present. Infusion of ₹ 28 crores for a 26% stake by Pharma Capital has its growth strategy.

The lab with a revenue of ₹ 75 crores is among top three Pathological labs in India with Atlantic (₹ 77 crores) and Pacific (₹ 55 crores). Yet its market share is only 2% of ₹ 3,500 crores market. The top 3 firms command only 6% as against 40-45% by their counterparts in the USA.

There are about 20,000 to 1,00,000 stand alone labs engaged in routine pathological business in India, with no system of mandatory licensing and registration. That is why Dr. Path Lab has not gone for acquisition or joint ventures. He does not find many existing laboratories meeting quality standards. His six labs have been accredited nationally whereon many large hospitals have not thought of accreditation. The College of American pathologists accreditation of Ray's lab would help it to reach clients outside India.

In Ray's Lab, the bio-chemistry and blood testing equipments are sanitised every day. The bar coding and automated registration of patients do not allow any identity mix-ups. Even routine tests are conducted with highly sophisticated systems. Technical expertise enables them to carry out 1650 variety of tests. Same day reports are available for samples reaching by 3 p.m. and by 7 a.m. next day for samples from 500 collection centres located across the country. Their technicians work round the clock, unlike

competitors. Home services for collection and reporting is also available. There is a huge unutilised capacity. Now it is trying to top other segments. 20% of its total business comes through its main laboratory which acts as a reference lab for many leading hospitals. New mega labs are being built to encash preclinical and multi-centre clinical trials within India and provide postgraduate training to the pathologists.

Questions

- (i) What do you understand by the term Vision? What is the difference between 'Vision' and 'Mission'? What vision Dr. Path Lab had at the time of inheritance of Ray's Lab? Has it been achieved? (10 Marks)
- (ii) For growth what business strategy has been adopted by Dr. Path Lab? (4 Marks)
- (iii) In your opinion what could be the biggest weakness in Dr. Path's business strategy? (6 Marks)

PART-B&C

(Answer **ANY THREE** questions from this part)

- 4. (a) What are the important steps necessary for creation and management of good alliance? (10 marks)
 - (b) Discuss the problems faced by the technology recipient companies under the technology transfer agreements? (10 marks)
 - 5. (a) What are Trade Policy Reviews? Explain its objectives under WTO. (10 marks)
 - (b) List out the sectors/activities where FDI is permitted. (10 marks)
 - 6. (a) Explain the procedure to be followed for making an application with regard to dumping and material injury. (10 marks)
 - (b) What is the purpose of 'boxes' under WTO? (10 marks)
 - 7. (a) Dumped imports are causing or threatening to cause, material injury to the Indian domestic industry. Explain. (10 marks)
 - (b) Explain the principles of a specific subsidy under SCM Agreement. (10 marks)
 - 8. (a) Write short notes on:
 - (i) Rule of Origin
 - (ii) Trade Distortion(5 marks each)
 - (b) Explain the role and function of Dispute Settlement Body. (10 marks)
-

TEST PAPER 4/2011

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer All Questions.

PART-A

(Answer **ANY TWO** questions from this part)

1. (a) Strategic management is an externally oriented philosophy of managing an organization. Discuss the functions required as an explicit philosophy of managing an organization. (5 marks)
- (b) The essential requirements for the success of a business are the implementation of organizational objectives, plans and philosophy. With this end in view, mention the elements of internal control. (5 marks)
- (c) Describe the construction of BCG matrix and discuss its utility in strategic management. (10 marks)
2. Enumerate in logical sequence the steps involved in respect of the following :
 - (i) Business process re-engineering
 - (ii) Value chain analysis
 - (iii) Strategic group mapping
 - (iv) Bench marking process. (5 marks each)
3. Read the following case and answer the questions at the end:

Sony is the India's premier public service broadcaster with more than 1,000 transmitters covering 90% of the country's population across an estimated 70 million homes. It has more than 20,000 employees managing its metro and regional channels. Recent years have seen growing competition from many private channels numbering more than 65, and the cable and satellite operators (C & S). The C & S network reaches nearly 30 million homes and is growing at a very fast rate.

Sony's business model is based on selling half-hour slots of commercial time to the programme producers and charging them a minimum guarantee. For instance, the present tariff for the first 20 episodes of a programme is ₹ 30 lakhs plus the cost of production of the programme. In exchange the producers get 780 seconds of commercial time that he can sell to advertisers and can generate revenue. Break-even point for producers, at the present rates, thus is ₹ 75,000 for a 10 second advertising spot. Beyond 20 episodes, the minimum guarantee is ₹ 65 lakhs for which the producer has to charge ₹ 1,15,000 for a 10 second spot in order to break-even. It is at this point the advertisers face a problem – the competitive rates for a 10 second spot is ₹ 50,000. Producers are possessive about buying commercial time on Sony. As a result the Sony's projected growth of revenue is only 6-10% as against 50-60% for the private sector channels. Software suppliers, advertisers

and audiences are deserting Sony owing to its unrealistic pricing policy.

Sony has three options before it. First, it should privatise, second, it should remain purely public service broadcaster and third, a middle path.

The challenge seems to be to exploit Sony's immense potential and emerge as a formidable player in the mass media.

Questions

- (i) What is the best option, in your view, for Sony? (8 marks)
- (ii) Analyse the SWOT factors the Sony has. (7 marks)
- (iii) Why do you think that the proposed alternative is the best? (5 Marks)

PART-B&C

(Answer **ANY THREE** questions from this part)

- 4. (a) Prepare a checklist capturing the key points for a company's alliance strategy. (10 marks)
 - (b) A trust and a society, registered in India, are intending to invest in a joint venture outside India. Advise. (10 marks)
 - 5. (a) Draft following clauses to be included in joint venture agreements:
 - (i) Secrecy
 - (ii) Force Majeure (5 marks each)
 - (b) List out the sectors/activities where FDI are prohibited. (10 marks)
 - 6. (a) What are the different kinds of Intellectual Property protected by TRIPS? How it is protected? (10 marks)
 - (b) Elucidate the Tariff and Non-tariff barriers in International Trade. (10 marks)
 - 8. Write short notes on the following:
 - (i) European Court of Justice
 - (ii) Agreement on Safeguard
 - (iii) Green Box under Agricultural Agreement
 - (iv) Geographical Indication. (5 marks each)
-

TEST PAPER 5/2011

Time allowed: 3 hours

Maximum marks : 100

PART-A

(Answer **ANY TWO** questions from this part)

1. (a) Attempt ANY TWO of the following:
 - (i) "SWOT Analysis is a strategic planning tool". Comment.
 - (ii) Forecasting should not be considered the only element of the strategic planning process in the organization. Discuss.
 - (iii) "Impact analysis" is a brainstorming technique". Do you agree? If yes, why, if no, why not? (5 marks each)
- (b) Distinguish between the following:
 - (i) Vision and mission
 - (ii) Strategic planning and Tactical planning. (5 marks each)
2. (a) State with reasons in brief whether the following statements are *correct* or *incorrect* :
 - (i) Strategy follows structure.
 - (ii) Substitute products are those products which serve different customer needs.
 - (iii) Vertical integration is a situation when two or more similar firms join hands.
 - (iv) Harvesting was popularized by Porter.
 - (v) Retrenchment implies downsizing of business.
 - (vi) Budget is a statement of a company's programmes in financial terms. (2 marks each)
- (b) Discuss General Electric Model of analyzing business portfolio (8 marks)
3. (a) "Risk always carries cost". Do you agree? Comment. (8 marks)
- (b) Write short notes on ANY THREE of the following:
 - (i) Constraints in operating a MIS
 - (ii) Internal Audit
 - (iii) Artificial intelligence
 - (iv) PEST Analysis. (4 marks each)

PART-B&C

(Answer **ANY THREE** questions from this part)

4. (a) What is meant by strategic alliance? Discuss its advantages. (10 marks)
- (b) 'Synergy' is the aim and intent of joint venture? What are the various modes of

joint venture?

(10 marks)

5. (a) Describe the objectives and fundamental principles of SAARC. *(10 marks)*
(b) "WTO is a rule based system". Discuss. *(10 marks)*
6. (a) Enumerate the various provisions of GATS regarding services. *(10 marks)*
(b) What is meant by 'dumping'? Explain various types of dumping. *(10 marks)*
7. (a) What is the basic rationale behind countervailing measures. *(10 marks)*
(b) Explain the various instruments of international trade policy? *(10 marks)*
8. Write short notes on:
- (i) Comparative Advantages
 - (ii) Cross Border Supply
 - (iii) Commercial Presence
 - (iv) Safeguard duty. *(5 marks each)*
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PROFESSIONAL PROGRAMME
**STRATEGIC MANAGEMENT, ALLIANCES AND
INTERNATIONAL TRADE**

QUESTION PAPERS OF PREVIOUS SESSIONS

Question papers of immediate past two examinations of Strategic Management, Alliances and International Trade paper are appended to this study material for reference of the students to familiarize with the pattern and its structure. Students may please note that answers to these questions should not be sent to the Institute for evaluation.

DECEMBER 2010

Time allowed: 3 hours

Maximum marks: 100

PART A

(Answer ANY TWO questions from this part)

1. (a) In the context of strategic management, discuss, with reasons in brief, any five of the following statements:
 - (i) Napoleon used to say, "It is all in the execution".
 - (ii) There is often a fight to finish in the modern business world. Individual units and companies either die (fold up) or get 'eaten up' (acquired, etc.) while in animal world, once a contestant accepts defeat, he is left to lick his wounds alone.
 - (iii) Strategic management is a term broader than strategy itself.
 - (iv) There are no foreign lands. It is the traveller only who is foreign.
 - (v) A company faced with decline in fortunes has only one option of adopting liquidation strategy.
 - (vi) Benchmarking is the break-in-process of measuring products, services and practices against the competitors and companies recognised as industry leaders. *(2 marks each)*
- (b) Write notes on the following:
 - (i) Stability strategies
 - (ii) Decision support system (DSS). *(5 marks each)*
2. (a) Discuss the constraints that exist in operating a 'management information system' (MIS). *(8 marks)*
- (b) "McKinsey framework shows that there is a multiplicity of factors that

influence an organisation's ability to change." Discuss. (8 marks)

(c) "The function of the internal control is to enable the adopted plan to operate efficiently, profitably and economically." Comment. (4 marks)

3. Distinguish between any four of the following :

(i) 'Corporate strategies' and 'business strategies'.

(ii) 'Market value added concept' and 'economic value added concept'.

(iii) 'Vision' and 'mission'.

(iv) 'Internal audit' and 'internal check'.

(v) 'Market risk' and 'business risk'. (5 marks each)

PART B

(Answer ANY ONE question from this part)

4. Read the following case and answer the questions given at the end:

Tata Tea and PepsiCo appear to have agreed in-principle to set-up a joint venture (JV) for non-carbonated, health and wellness beverages to explore the low cost, bottom-of- pyramid segment beverages. The JV is considering leveraging the Tata brand and expertise in low-cost consumer products and coupling it with PepsiCo's distribution muscle, go-to-market expertise and R&D strength in beverages. The proposed JV may consider wellness packaged water initially followed by other beverages. The JV's focus on the lower end of the market will ensure that PepsiCo's existing alliance with Hindustan Unilever to sell Lipton ice tea, which focuses on mid-to-premium segment, will not be impacted. The new tie-up will give PepsiCo the opportunity to be perceived as a wholesome beverages company making fizzy drinks. Tata Tea will get a larger foothold in the wellness beverages segment after an earlier attempt to foray in the category had to be aborted within a year. Tata Tea, through its indirect UK subsidiary, Tata Tea (GB) Investments, has picked up 30% stake in the US based maker of vitamin water 'Glaceau' in mid 2006 for \$677 million. But in 2007, Tata Tea had to sell off its 30% stake in Energy Brands Inc., which owns Glaceau—to beverage giant Coca-cola for \$1.2 billion, less than a year after it acquired the stake. Though, Tata Tea has been aggressive in acquiring companies in the beverages sector including Tetley, Eight O'clock Coffee and Good Earth, its wellness and health beverages portfolio in India so far is limited to Himalayan packaged water and Ti.'ON, an energy drink made from fruit juice and tea extracts. Ti.'ON is not a national brand yet. It is also important to note that PepsiCo's partnership with Hindustan Unilever for distributing Lipton iced tea in India did not take off in the way both companies expected to. Tata Tea and PepsiCo have said, "The proposed joint venture, is not intended to conflict with any existing arrangements of either party." Though, ₹. 7,000 crore aerated soft drink market has been growing at a healthy 20% plus in India, PepsiCo has been expanding its portfolio in the health and wellness space aggressively globally as well as in the domestic market, in line with its ambition of being a global leader in the 'good for you' beverages segment.

PepsiCo's existing health and wellness brands include packaged water AcquaFina, Tropicana juices, Nimbooz nimbu pani and sports drink Gatorade.

Questions —

- (i) Is joint venture the only way to enter into strategic alliance?
 - (ii) Alliances are not new, but in the competitive landscape, distinguishing features are emerging. Identify these features.
 - (iii) Is strategic alliance different from merger and when does an alliance become a merger?
 - (iv) What reasons can you anticipate that Tatas had to sell Glaceau to Coca-Cola within such a short time? *(5 marks each)*
5. (a) Discuss the procedure for foreign direct investment in India. *(8 marks)*
- (b) Discuss the problems associated with technology transfer agreements. *(8 marks)*
- (c) State the categories for which government approval through Foreign Investment Promotion Board (FIPB) route is necessary. *(4 marks)*

PART C

(Answer ANY TWO questions from this part)

6. The South Asian Association for Regional Co-operation (SAARC) comprises Bangladesh, Bhutan, India, The Maldives, Nepal, Pakistan and Sri Lanka. The main goal of the association is to accelerate the process of economic and social development in member States, through joint action in the agreed areas of co-operation. The idea of regional co-operation in South Asia was first mooted in November, 1980. After consultations, the Foreign Secretaries met in Colombo in April, 1981, which was followed by the meeting of the Committee of the Whole, which identified five broad areas for regional co-operation. The Foreign Ministers at their first meeting in New Delhi in August, 1983 formally launched the Integrated Programme of Action through the adoption of the Declaration of South Asian Regional Co-operation. At the first Summit in Dhaka on 7-8 December, 1985, the charter establishing the SAARC was adopted.

Answer the following questions :

- (i) What are the objectives of SAARC ?
 - (ii) Discuss the institutional structure of SAARC.
 - (iii) Explain the role of SAARC Chamber of Commerce and Industry.
 - (iv) "SAARC has miserably failed to perform and fulfill its objectives, but it must succeed." Comment. *(5 marks each)*
7. (a) State, with reasons in brief, whether the following statements are true or false:
- (i) The Harmonised Code for custom classification, custom valuation

and rules of origin are the three basic custom laws.

- (ii) Safeguard measures and anti-dumping actions and countervailing duties are one and the same.
 - (iii) Regional trade agreements are entered into only between neighbouring countries.
 - (iv) Trade policy mechanism has no utility. *(2 marks each)*
- (b) Write notes on the following:
- (i) Limitations of dispute settlement procedure mechanism under the WTO.
 - (ii) Role of Director General of the WTO. *(6 marks each)*
8. (a) What are the different kinds of intellectual property rights protected by Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement? *(4 marks)*
- (b) What are the remedies against prohibited subsidies? *(4 marks)*
- (c) "Injury analysis can be broadly classified into two categories." Elucidate. *(4 marks)*
- (d) Briefly discuss the duration and review of countervailing duties. *(4 marks)*
- (e) What are anti-dumping actions? *(4 marks)*
-

JUNE 2011*Time allowed : 3 hours**Maximum marks : 100***PART A***(Answer ANY TWO questions from this part.)*

1. (a) Distinguish between the following :
- (i) 'Market risk' and 'business risk'.
 - (ii) 'Delphi techniques' and 'cross impact analysis'.
 - (iii) 'Concentric diversification' and 'conglomerate diversification'.
 - (iv) 'Management information system' and 'decision support system'.
 - (v) 'Inter-firm comparisons' and 'intra-firm comparisons'.
- (3 marks each)*
- (b) As a Company Secretary, how would you perceive the 'risk elements' that a shareholder will have in a company from financial risk point of view?
(5 marks)

2. It is passenger operation which helps people at large connect with Indian Railways (IR). And yet, passenger services have generally been viewed by IR management largely as social service obligation. Passenger business have inflicted an annual loss of over ₹.20,000 crore. Earnings of ₹.23,488 crore from passenger traffic in 2009-10 accounted for only 27% of IR's gross revenues; freight earnings of ₹.58,502 crore contributed 65%.

Passenger business worldwide accounted for 57% and freight 43% of the \$313 billion global rail market (in 2005). Not that railway passenger business is inherently loss-making. On IR, it is the ordinary second-class segment that is the major culprit. While the second class mail/express fare was 23.1 paise per km. in 2000-01; it remained stubbornly stuck at 23.2 paise per km. even in 2008-09. The ordinary second-class fare, largely responsible for loss-making, has remained untenably low at 14.9 paise per km. and suburban travel still lower, at 12.9 paise per km. The fare on State road transport services in 2008-09 averaged 48.37 paise per km.

About 10 million passengers in India travel by air in a month, IR transports twice as many in a day. Even so, IR accounts for a meager 12% of India's total passenger traffic, roads carrying over 87%. Cost-effective rail travel demand, far outstripping supply, will further grow substantially in view of the country's declining agriculture sector driving migration from rural areas for an integrated national labour market. The urban population is projected to rise from current 286 million to 575 million by 2030, keeping the population on the move. Also, the specter of climate change favours IR to reposition rail travel in preference to car and airlines.

There is projection of 7,189 million inter-city passengers by 2025-26 against 2,835 million passengers in 2007-08. If GDP grows 8% or more, annual demand for transport generally rises 10-12%, implying the number of originating non-suburban rail passengers exceeding 12,000 million by 2025.

On the basis of above case study, you are required to answer the following questions as the CEO of Indian Railways:

- (i) Describe the environmental factors responsible for performance of railways as a commercial entity. (5 marks)
 - (ii) Describe components of a strategic plan for railways to meet passenger demand highlighting consideration for each component. (10 marks)
 - (iii) Write a note on commercial revival of IR using Gap Analysis. (5 marks)
3. (a) Suggest ways to overcome resistance to change. Which is the least effective style of managing change and why ? (10 marks)
- (b) What are the ten 'P' elements of risk in business ? Describe at least one element for each 'P'. (10 marks)

PART B

(Answer **ANY ONE** question from this part.)

4. (a) Hero Honda joint venture formed in 1984 is a classic case of strategic alliance involving the Indian company Hero Group and Japanese automobile major Honda Motorcycle. The alliance has been terminated with the entire 26% stake of Honda Motorcycle in the venture bought by the Hero Group. Selling out of the venture gives the Japanese company the freedom to go it alone in the world's second largest market for two-wheelers.
- (i) List out the advantages of the strategic alliance for both the organisations, in two-wheeler market in India. (5 marks)
 - (ii) What are the key success factors for managing an alliance ? In the light of these key success factors, identify the reasons for the termination of this successful joint venture. (5 marks)
- (b) Assuming that High Speed Auto Ltd. intends to acquire technical know-how to produce a small car for the Indian market in collaboration with a German car manufacturer, specify the broad issues to be covered in the agreement for foreign technical services in India. (10 marks)
5. Describe in brief the following in connection with direct investment outside India by an Indian company in an overseas joint venture (JV)/wholly owned subsidiary (WOS) under automatic route of FEMA :
- (i) Different methods of funding of investment.
 - (ii) The conditions to be fulfilled for investment by an Indian entity engaged in financial sector.
 - (iii) The conditions for capitalisation of exports and other dues.
 - (iv) Compliances of reporting of initial investment, subsequent investment and filing of annual returns.
 - (v) Conditions for allowing investments in JV/WOS through the medium of a special purpose vehicle (SPV). (4 marks each)

PART C

(Answer **ANY TWO** questions from this part.)

6. (a) State the similarities and differences between 'anti-dumping duty' and 'countervailing duty'. (5 marks)
- (b) Highlight the differences between GATT and WTO. (5 marks)
- (c) Elucidate the concept of 'most favoured nation' (MFN). (5 marks)
- (d) Describe the significance of 'rules of origin' under WTO system for ensuring fair international trade. (5 marks)
7. (a) Under the Madrid and Hague Systems dealing with the international registration of marks and industrial designs, match the following :
- | | |
|--------------------------|--|
| (i) Strasbourg Agreement | (a) Concerns with establishing an international classification for industrial designs. |
| (ii) Nice Agreement | (b) Establishing an international classification of the figurative elements of marks. |
| (iii) Vienna Agreement | (c) Concerning the international classification of goods and services for the purposes of the registration of marks. |
| (iv) Locarno Agreement | (d) Concerning the international patent classification. |
- (1 mark each)
- (b) State, with reasons in brief, whether the following statements are true or false :
- (i) Anti-dumping cases initiated by WTO have increased significantly since mid 1990s.
- (ii) Trade creation describes the situation where the removal of tariff barriers between members of the trading bloc now enable various products to be purchased at lower prices, thereby stimulating intra-regional trade. (1 mark each)
- (c) Attempt the following :
- (i) Which two of the following are the most likely effects of the imposition of a tariff on an imported good —
- The domestic price of the imported good will fall
 - Overseas production of the good may be stimulated
 - Overseas unemployment will come down
 - The domestic price of the imported good will rise
 - Gain of tax revenue by the Government.
- (ii) Which two of the following arguments are used by critics of free trade —

- (a) Free trade does not take into consideration the productivity differences between countries
 - (b) Free trade may lead to unemployment
 - (c) Free trade often ignores the effects of monopoly elements on consumer welfare
 - (d) Free trade can only work within trading blocs
 - (e) Free trade reduces international specialisation.
- (iii) Which two of the following are the most integrated forms of regional trading arrangement —
- (a) Customs Union
 - (b) Economic Union
 - (c) Free trade area
 - (d) Multilateral trading area
 - (e) Common markets. *(1 mark each)*
- (d) Explain the concept of 'boxes' under WTO terminology for agriculture agreement and briefly describe each of them. *(6 marks)*
- (e) What are the principles of multilateral trading system under WTO? *(5 marks)*
8. (a) Re-write the following sentences after filling-in the blank spaces with appropriate word(s)/figure(s) :
- (i) The _____ of goods imported into India is the price paid or payable for the goods by the first independent buyer.
 - (ii) _____ is the first ever set of multilateral, legally enforceable rules covering international trade in services.
 - (iii) The Third WTO Ministerial Conference, 1999 was held in _____ between 30th November, 1999 and 3rd December, 1999.
 - (iv) _____ increases the price of imported goods.
 - (v) The _____ introduced the term 'European Union' in November, 1993. *(1 mark each)*
- (b) "The subsidies and countervailing measures (SCM) agreement creates three narrowly defined categories of non-actionable subsidies." Explain. *(5 marks)*
- (c) Briefly describe the role of appellate body in review of the panel report when a party to trade dispute files appeal against the panel report. *(5 marks)*
- (d) Doha Ministerial Conference, 2001 has failed to fulfill its commitment to correct and prevent restriction and distortion in world agricultural market. Do you agree ? Discuss. *(5 marks)*