Organizational Decline and Turnaround Management: A Contingency Framework

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This study examines the reasons for organizational decline and suggests context-specific turnaround process. The decline is primarily an outcome of inaction of managers and inappropriate actions of managers in response to environmental reality. The causality variables to explain inaction and inappropriate actions are of two types: a) organization-specific like past experiences, sunk investment, specialized assets, bureaucratic control, internal political and cultural constraints, managerial commitment to *status quo* and b) environment-specific like legal, political, social, and economic constraints. The turnaround process of declining organizations needs to be tailored to match the contextual reality. This paper develops a contingency framework to explain context-action choice relationship.

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Introduction

Globally, the threat of decline has been increasing in both the manufacturing and service industries both at times of economic recession and relatively prosperous years (Witteloostuijn, 1998; Cameron *et al.,* 1988a) in both developed and developing nations. In India, the percentage of loss making companies has consistently increased in the last decade (Table 1).

Such frequent loss making performance and frequent sub-optimal performance by companies has resulted into organizational decline and turnaround management to emerge as one of the most important topics, addressed by business education and research in recent years. The

Table 1: Loss Making Companies in India

Year	*% of Companies that Reported Losses*	*Number of Companies that Reported More than Rs* 7 Billion Loss (at Current Price)*
1990	19.50	6
1991	18.04	6
1992	17.60	8
1993	19.47	16
1994	16.05	23
1995	14.04	16
1996	22.41	23
1997	31.77	30
1998	35.88	33

Note: Based on data provided by the Centre for Monitoring Indian Economy (CMIE). Hence, all companies documented by CMIE on year-to-year basis are included in the analysis.
*Rupee is currently traded at approximately 1 US$ = Rs 46.50.

literature on turnaround management of declining firms has contributions from psychology, sociology, economics, anthropology, history, and management fields. Now there is a need to develop a comprehensive framework by integrating those contributions. Such framework would help the managers to address the problems of declining organizations by pre-empting declining conditions and ameliorating declining conditions. In this paper, an attempt is made to develop a comprehensive framework that will provide guidance for future research, help practising managers, and develop sound theoretical base in this field.

Decline and Turnaround Management Research

Literature on decline and turnaround management can be identified to address the following questions:

Why do firms decline (Witteloostuijn, 1998; Khandwalla, 1992; Hambrick and D'Aveni, 1988; Singh, 1986; Zammuto and Cameron, 1985; Hannan and Freeman, 1977; Argenti, 1976)?

What are the consequences of firms' decline on social, psychological, economic, and political issues within and outside the organization (Khandwalla, 1992; Sutton and Callahan, 1987; Harris and Sutton, 1986)?

How do firms respond to decline (Witteloostuijn, 1998; Barker, III and Duhaime, 1997; Ruiz-Navarro, 1998; Khandwalla, 1992; D'Aveni, 1989; Ford and Baucus, 1987; Sutton and Callahan, 1987)?

Causes of Decline

The causes of decline are identified along two lines: a) external to organization (Mone *et al.* 1998; Khandwalla, 1992; Kelly and Amburgey, 1991; Cameron, 1988a) and b) internal to organization (Cameron, 1988a). Population-ecology (Aldrich and Pfeffer, 1976) and life cycle theories (Carrol, 1984) provide perspectives to understand and examine the external causes of decline of organization. Population-ecology theory proposes the survival of those organizations that are able to align their strengths and weaknesses with the environmental niche due to limited carrying capacity of the environment. Organizations that fail to align with the environment are pushed out of it.

Hence, organizational inertia, causing slow responsiveness to the changes in the environment, leads to the decline of organizations. Organizations that try to adopt safer domain and carve a congenial niche are not able to respond to sudden changes in the environment, leading to decline. For example, Indian Telephone Industries Ltd. (ITI) remained prosperous in the protected environment as the Department of Telecommunication (DoT) ensured the purchase of its products. The organization developed inertia due to this protected environment and failed to develop in-house technological capability. In the post-liberalization scenario, the arrival of foreign giants like AT&T and Ericsson into the country brought new products and DoT started purchasing more than two-thirds of its requirements from these and other such organizations. ITI found it hard to respond to these changes in the environment and started declining. The Indian capital market valued the company at Rs 1.61 billion (on October 31, 2000) though it carries a net worth of Rs 2.6 billion in its books of accounts.

Lack of initiative, as in the above case, primarily arises from inertial pressure arising from sunk investment, specialized assets, bureaucratic control, internal political and cultural constraints, external restrictions, and managerial commitment to *status quo* due to their longer tenure in the organization and in the industry (Hambrick *et al.,* 1993; Ghemawat, 1991).

Excessive initiative beyond the firms' technical and financial capacity to alter the product-market domain has also been the cause of decline for many firms. Core Healthcare Ltd. was the market leader in Asia in intravenous fluid. Its PAT/sales ratio was 27.4 per cent on its sale of Rs 1337.4 million in 1995. In 1996, the company made an aggressive entry into new global markets and new product domains beyond its financial and managerial capabilities. It borrowed heavily from the market for such expansion resulting in high interest cost. This highly profitable company reported loss for the first time in 1997. Its net worth got completely eroded in March 2000. The company has been referred to the Board for Industrial and Financial Reconstruction (BIFR) in India under the Sick Industrial Companies (Special Provisions) Act (SICA), 1985. Managers in firms undertaking such aggressive and extremely fast domain initiatives that are beyond the firms' capabilities have very little resources to react to contingentcies.

The systems theory of organizations is used to identify different vicious circles that afflict the organizations (Khandwalla, 1992). These circles could be triggered by excessive control of management or by under control of the management. Excessive control of management is triggered by lack of organizational slack (Staw *et al.,* 1981; Bozeman and Slusher, 1979). Organizational slack such as surplus managerial and technical capabilities and financial resources is important for managers to allow experimentation with ideas and reduce the control. To turn around firms, it becomes important to break this circle by arranging funds and other capabilities to take product-market initiatives. These funds are generally arranged with the help of financial institutions and retrenchment of assets. Restoring the liquidity of the firm remains one of the initial tasks of turnaround leaders.

Further, studies indicate that excessive slack also leads to complacency and such firms engage in minimal adaptive initiative (Hambrick and D'Adveni, 1988). For example, the Gramophone Company of India Ltd. (GCIL), a subsidiary of Electric and Musical Industries Limited, London (EMI) was highly profitable till 1981. The company became complacent to the market changes and did not react quickly to the emerging challenge to its music business in India after the advent of cassette technology. It incurred a loss of Rs 42.5 million in 1983 and was finally sold to the RPG group in India.

Consequences of Decline

The Resource-Dependence Theory (Pfeffer and Salancik, 1978) and Transaction Cost Theory (Williamson, 1985) of organizations are used to examine the consequences of decline both within and outside the organization (Mone *et al.,* 1998; Khandwalla, 1992; Sutton and Callahan, 1987; Harris and Sutton, 1986). The focus of researchers has been to delineate the impact of decline on the behaviour of suppliers, customers, employees, and the top management, and on the learning process, control, and information flow processes in the organization.

The cost of transaction with the environmental components increases under declining conditions. Suppliers, creditors, customers, and other organizational audience try to disengage themselves from the organization, reduce the quality of participation, bargain for more favourable exchange relationship, denigrate the organization via rumours and denigrate the organization via confrontation (Sutton and Callahan, 1987). Such reactions adversely affect the career, reputation, and self-efficacy of the top management in the declining organization. Managers try to avoid or delay emergence of such reactions by increased secrecy, rigidity, centralization, formalization, scapegoating, conflict, and conservatism. This further increases the severity of decline of the organization (Khandwalla, 1992).

However, in Indian conditions, many a times, promoters of sick private enterprises do not generally suffer. They often recover their cost even before the launch of the project through under-voicing or over-voicing of the machinery, etc. (Vittal, 1998). Moreover, SICA, 1985 has provision to assist companies through different relief measures. These measures include loans at lower interest rates for their revival. However, such financial relief is possible only if the management of the company is able to convince the financial institutions about the viability of the revival plan. Generally, the initial response of banks is to oppose any such revival plan that calls for more investment by them.

Emergence of consensus of different stakeholders about the action plan for the company takes a minimum 2-3 years in India after the company is referred to BIFR under the present working of SICA, 1985. This delay causes further decline in performance thus making this process of turning around the company unviable many a times.

Response to Declining Conditions

This stream of research is concerned about the process of turnaround of declined organizations (Ruiz-Navarro, 1998; Khandwalla, 1992; Robbins and Pearce II, 1992). Most of the studies in this field seem to be using contingency-rational model of organizations. However, empirical studies in this stream experience methodological problems to develop the theory of turnaround management. Primarily, there have been three methods of inquiry. First, researchers have tried to use quantifiable variables (Witteloostuijn, 1998; Robbins and Pearce II, 1992; O'Neill, 1986; Hambrick and Schecter, 1983; Schendel, Patton, and Riggs, 1976). Second, case method (Ruiz-Navarro, 1998; Khandwalla, 1981, 1989; Mukherji, 1989; Potts and Behr, 1987; Kharbanda and Stallworthy, 1987; Sutton and Callahan, 1987; O'Neill, 1986; Hegde, 1982; Bibeault, 1982) is used. Third, efforts are made to gain insight into the process of turnaround through analysis of published cases (Khandwalla, 1992).

Researchers have tried to develop typology of turnaround strategies in this field of inquiry. Khandwalla (1992) identifies four basic types of turnaround processes namely surgical-reconstructive, surgical-innovative, non-surgical-innovation, and non-surgical-transformational. His analysis of 65 published turnaround cases indicates that domain initiative, cost reduction, and top management changes are some of the universal activities in the turnaround process. However, Robbins and Pearce II (1992) identify two types of strategies: a) efficiency driven with belt tightening and streamlining of operation, and b) competitive strategy-oriented with changes in technology, products, or markets. The contrast between the two is apparent. While Khandwalla (1992) identifies cost reduction as an essential activity in the turnaround process, it is one of the strategic options for the latter.

Components of Framework and their Relationship

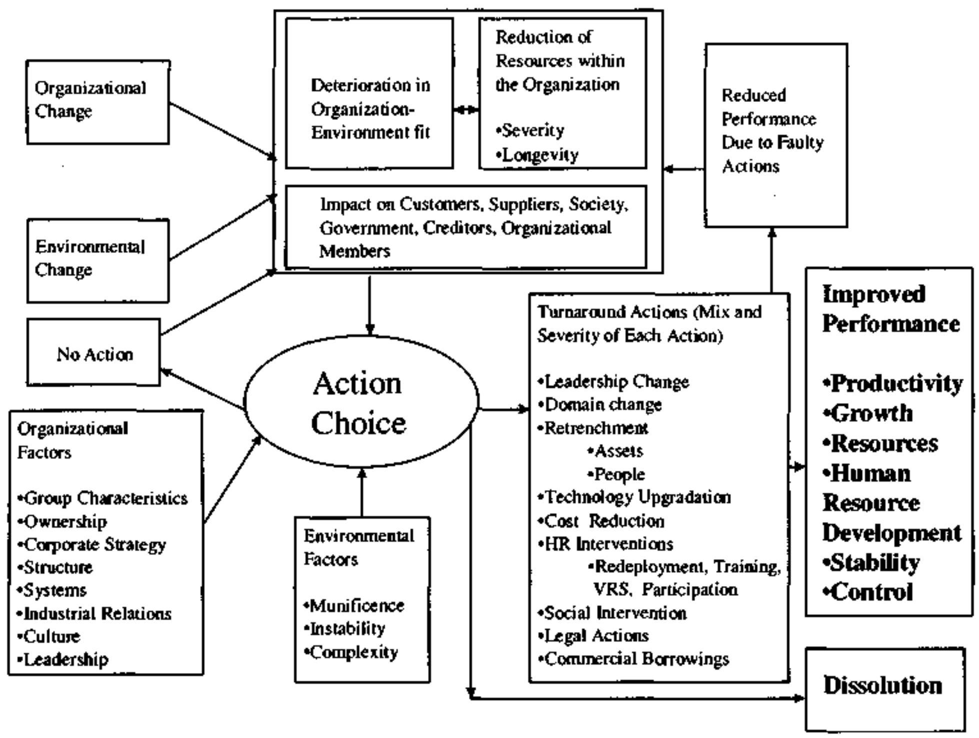
There are multiple perspectives and dimensions to understand organizational decline and turnaround management as discussed in the above sections. Researchers have looked at different elements of decline and turnaround management with different perspectives. Now, there is a need to have an integrated framework to develop holistic understanding of decline process and turnaround management. Such a framework will guide our future research efforts to develop comprehensive theory to predict, preempt, and turnaround the declining conditions. The next section develops such an integrated framework for the study of decline and turnaround management.

Figure 1 shows an integrated framework of organizational decline and turnaround management. The framework integrates all the three critical issues related to organizational decline and turnaround management. Action choice is central to the framework as it is influenced by and it influences the decline process, impact on different members of the organization and environment and the turnaround process.

Decline Process

The process of decline starts with the changes in the environment and/or in the characteristics of the organization. The managerial inadequacy to restore the fit between the two starts the decline process in the organization. Khandwalla (1989) identified inadequate management as the primary cause for decline of firms. He emphasizes appropriate corporate governance and timely intervention by other stakeholders such as financial institutions, regulatory bodies, and employees to ensure organizational health. The role and composition of the audit committee of the company board is critical for timely diag-

Figure 1: Framework of Organizational Decline and Turnaround Management



nosis and intervention. Active external members of repute in the audit committee are helpful for timely diagnosis of organizational sickness.

Decline process could be understood from stage theory of decline that suggests five stages: a) blinded, b) inaction, c) faulty action, d) crisis, and f) dissolution (Weitzel and Jonsson, 1989). Blinded stage is the lack of anticipation of changes in the environment. Inaction is the failure to decide corrective action and decline becomes noticeable. Faulty action leads to crisis. It is perhaps the last chance to revival. Dissolution is the last stage of decline. These stages can be conceptualized in terms of action choices. Action choices, available to managers under declining conditions, are:

- Inaction, i.e. not to take any action in anticipation of natural cure of the problem or death.
- Actions for turnaround of the organization.
- Dissolution, i.e. closing the organization having no hope for its revival.

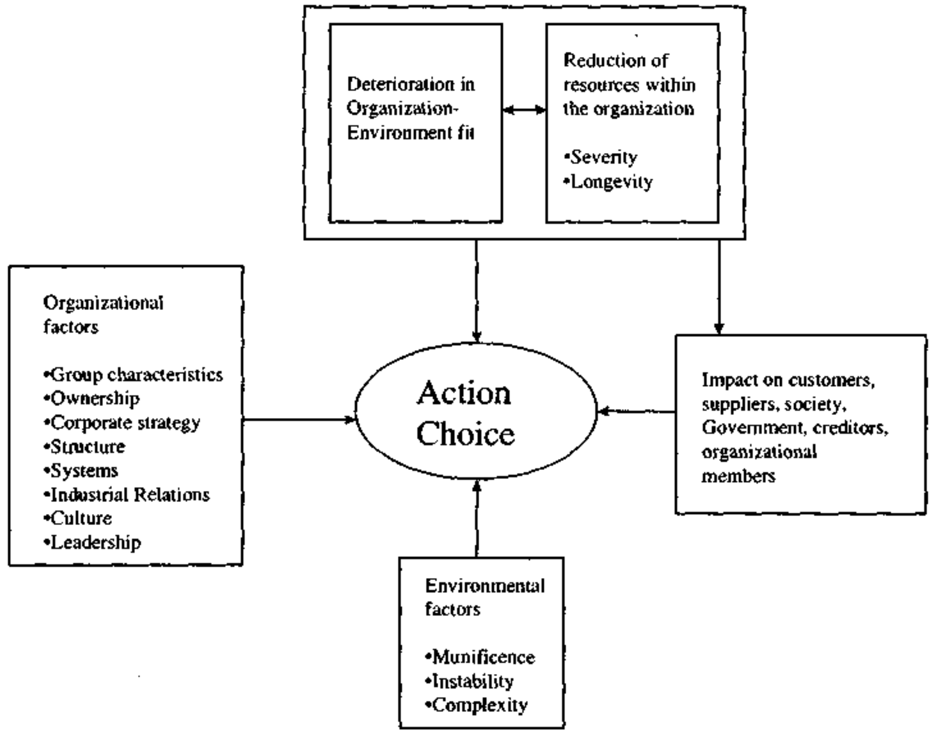
Variables Influencing the Action Choice

Selection of action choice is influenced by perceived environmental conditions, organizational reality (Papadakis *et al.,* 1998), severity and longevity of decline conditions, and reaction of different stakeholders to decline as indicated in Figure 2.

Environmental Factors

The cause of decline is primarily rooted in the managerial inadequacy to align the organization with the environment. This may be for two reasons: a) managerial perception of environmental reality may be erroneous leading to wrong action choice, and b) managerial inertia to continuously realign organization. Environmental reality could be examined along two dimensions: a) velocity of environmental change, and b) content of change (Zammuto and Cameron, 1985). When the velocity of environmental change is slow, it takes a long time for managers to realize the erosion of their niche (Zammuto and Cameron, 1985) leading to long periods of inaction and the start of blind phase of organ-

Figure 2: Factors Influencing the Action Choice



izational decline leading to reduction in organizational resources. Inaction at this stage increases the severity of the organizational decline that further influences the action choice as shown in Figure 3. However, in fast changing conditions, there will be quick dissolution of firms, giving them no opportunity to reorient their activities. Moreover, in high velocity environment, there is likely to be less inclination to employ both extensive search and explicit analysis of alternatives. Moreover, decisions under this condition carry relatively higher risk. Frequently, managers start seeking directives from the top management to avoid that risk taking. Hence, there may be attempts in such organizations to standardize their processes leading to higher inertia. This inertia delays managerial response to declining conditions.

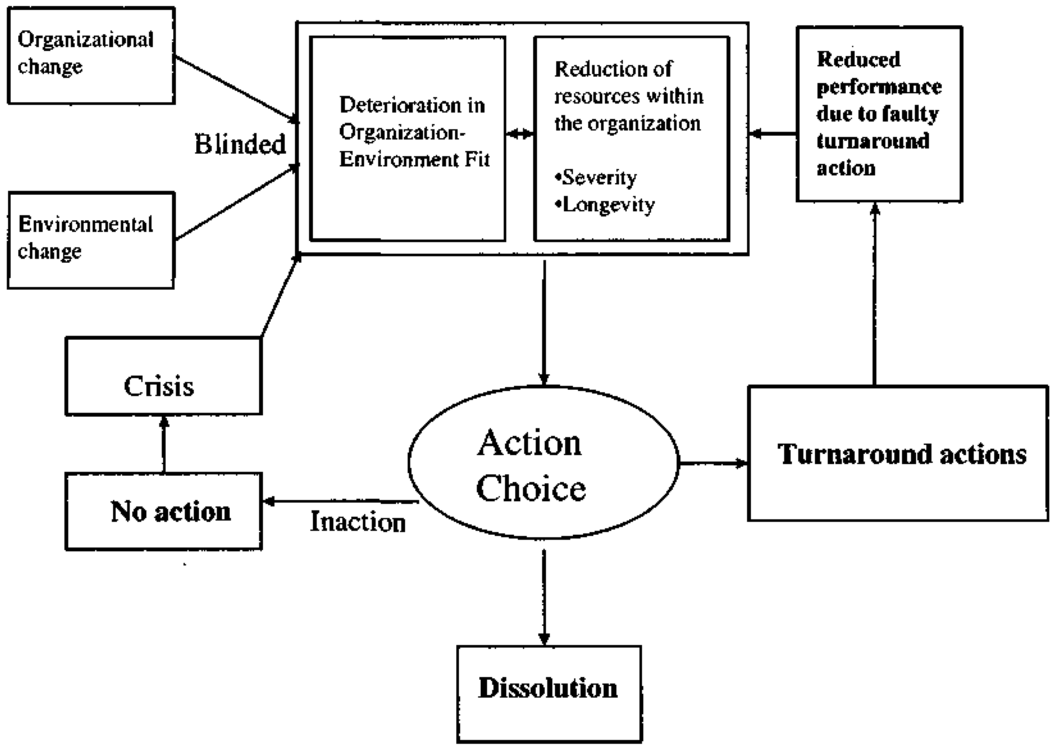
Environmental content could be conceptualized as consisting of instability, munificence, and complexity (Papadakis *et at.,* 1998). Research efforts have indicated different views on the impact of environmental instability on action choice (Papadakis *et al.,* 1998) primarily due to lack of isolation of control variables. This relationship is moderated by other environmental variables, e.g. munificence (Rajagopalan *et al.,* 1993) and complexity. Munificence refers to environment's carrying capacity. Higher munificence provides better opportunities in the environment to continue business.

When the environment is perceived to be moderate or high on munificence, it is likely that the management would prefer turnaround actions to dissolution of firms or inaction in anticipation to capitalize on opportunities in the environment. Hence, the extent and speed of organizational change under such conditions are expected to be high (Barker and Duhaime, 1997).

Organizational Factors

Organizational characteristics moderate the action choice of managers (Papadakis *et al.,* 1998). Organization-specific dimensions that influence the decision-making in the organization would include ownership, internal systems, corporate control, leadership characteristics, culture, age, size, and industrial relations.

Figure 3: The Decline Process



Ownership is traditionally conceptualized along two dimensions: a) nature, and b) extent. The nature of ownership could be government, independent organization, public-owned organization, or organization with controlling equity holding by a corporate house. The extent of ownership is conceptualized as the extent of equity holding by the major partner in equity partnership.

Organizations have multiple objectives. In the government-owned organizations, social objectives are given high importance along with financial objectives. In developing economies where unemployment rate is high, even declining government-owned organizations are required to continue their operations. Hence, such organizations are more prone to inaction and turnaround as against dissolution. Such organizations have longer inaction period due to increased inertia because of employment security and part financial security provided by the government, high formalization, and bureaucratic control. Continuance of 107 sick units out of 242 Government of India-owned enterprises (Vittal, 1998) is the reflection of the same. Hindustan Fertilizer Corporation, a loss-making Government of India-owned organization, has been recommended by BIFR to close some of its plants. However, there has been no action on it owing to unemployment problems.

Organizations owned by large corporate houses are likely to get response from the management based on the importance of the declining unit for the overall performance of the corporate house. Torrent Cable has virtually negligible integration with other businesses of Torrent business group in India. Lack of integration and relatively smaller size of the unit make it unimportant for the group. Hence, this loss-making unit of the group has not received serious attention of corporate management for its revival. This also emphasizes that audit committees of different companies in unrelated diversified corporate houses have to be highly vigilant for their health and survival.

The systems of organizations are expected to exert significant influence on the flow of information between the layers of hierarchy. They also determine the nature and context of human interaction (Papadakis, 1998). Such influences affect the action choice of managers in the organizations. Highly formalized and documented systems reduce the willingness to take risk among managers. Such systems further restrict the flow of relevant information and mass flow of irrelevant information. This along with bounded rationality causes limited systematic analysis of the situation. These factors along with size and age add to the inertia of organizations. For example, the management of Ashok Leyland, a large Heavy Commercial Vehicle manufacturing company in India with Rs 10 billion turnover, preferred inaction to wait for favourable market conditions when it faced a declining situation. There have been few efforts in the company to streamline some of the systems to make them more cost-effective, though the company reported losses in 1998-99 *(Business India,* April 20-May 3, 1999).

Core change attempts are slower with increased inertia (Kelly and Amburgy, 1991). Strong culture too adds to the inertia in the organization as it restricts the acceptance of new ideas as old ideas get strongly institutionalized. However, in organizations with strong culture, the chances of organizational death are generally less as such organizations normally enjoy support of many funding sources and realize greater financial and resource support from both internal and external constituents (D'Annuo *et al.,* 1991). Stakeholders are willing to help the organizations in difficult times due to history of successful operations.

There have been efforts to understand the impact of declining conditions on customers, suppliers, society, government, creditors, and organizational members and the influence of the same on action choice (Mone *et al.,* 1998; Barker and Duhaime, 1997; Khandwalla, 1992; Sutton and Callahan, 1987; Harris and Sutton, 1986). Sutton and Callahan (1987) observed that message of decline about an organization gives rise to a range of negative reactions by the audiences. Hence, management of relationship with stakeholders outside the organization becomes an important task of turnaround management. However, management under these reactions experiences stigma and lower self-efficacy. Therefore, change of leadership is almost a certainty to start the turnaround process. One of the most important initial tasks of the changed leadership in these conditions is to restore the confidence of people (Khandwalla, 1989) both internally and externally.

Declining organizations are likely to have better chances of revival when they have co-operative industrial relations between union and the management. Competitive industrial relations is likely to prompt the management to go for dissolution of the organization due to perceived difficulty in seeking the cooperation of unions to revive the units. Premier Auto Limited has not been able to turn around primarily because of conflicting industrial relations. Turnaround leaders are required to develop the confidence of trade union leaders and seek favourable response from other stakeholders.

Frequently, turnaround efforts are associated with retrenchment of people. Organization of parting ceremonies provides emotional support and schema editing to the people, leaving the organizations (Harris and Sutton, 1986). Such ceremonies are also used for member motivation, information dissemination, external stakeholder acceptance, impression management, and guilt management.

Performance Factors

Performance of organizations could be measured through growth, resource acquisition, productivity, human resource development, stability, and control (Rohrbaug, 1983). Organizational performance influences financial, technical, and managerial slack. However, the impact of slack on organizational action choice is not extensively researched (Rajagopalan *et al.,* 1993; Bourgeois, 1981). Superior performance leads to inertia in taking change action (Cyert and March, 1963). Cyert and March observed that superior performance that leads to organizational slack causes sub-optimal decision-making.

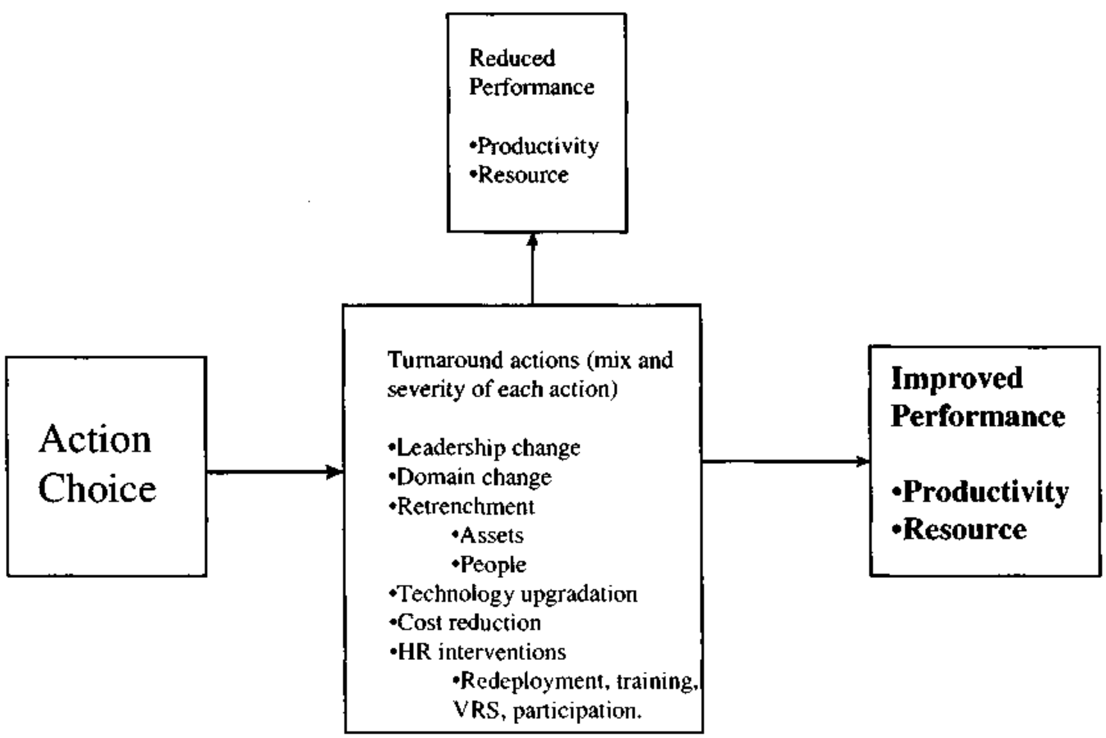
Delayed actions increase the severity of decline, i.e., organizational slack gets eroded to a large extent. With declining performance, stakeholders start influencing managers, forcing them to act. In a crisis situation, leadership change takes place to turn around the organization. Hence, in severe decline situations organizations experience actions either for the dissolution of the business or for turnaround. The choice would be contingent upon perceived environmental and organizational factors as discussed in previous sections.

Turnaround Process

Turnaround process starts with personnel change at the leadership position. This has consistently been indicated as a prerequisite (Khandwalla, 1992) to initiate turnaround actions due to escalated commitment of the existing leadership (Ghemawat, 1991) and restore the confidence of different stakeholders. This changed leadership initiates many actions to turn around the organizational performance. Researchers have devoted considerable attention to understand and examine turnaround actions. Most of these efforts have been to develop typology of turnaround actions (Schendel *et al.,* 1976; Ford and Baucus, 1987; Khandwalla, 1992; Robbins and Pearce II, 1992). The fundamental tenet of inquiry to develop typology has been to identify consistent mix of different actions. Figure 4 shows broad category of activities in turnaround actions.

Khandwalla (1992) identified 27 set of activities to be classified under seven broad groups namely: a) personnel changes, b) diagnosing and troubleshooting, c) stakeholder or people-management, d) operations management, e) management systems and structure, f) financial management, and g) strategic management. However, his typology of turnaround management (surgical reconstructive, surgical innovative, non-surgical innovative, non-surgical transformational) is based on retrenchment of people, technology upgradation, and people-management. He found that rest of the activities were common to most of the turnaround experiences. Zammuto and Cameron (1985) identify "k: innovation" type and "r: reduction" type strategies on the basis of domain change and cost reduction efforts. His argument for matching the turnaround strategy to the changes in the environment niche has received the attention

Figure 4: Turnaround Actions



of researchers. Robbins and Pearce II (1992) classify turnaround strategy into two types: a) efficiency driven, and b) competition driven. They are closer to "r" and "k" types of Zammuto and Cameron (1985). In reality, any turnaround effort will consist of a suitable mix of both.

Studies indicate that both excess and lack of domain change lead to crisis (Hambrick and D'Aveni, 1988). The study by Barker and Duhaime (1997) indicates that extent of domain change would increase with increase in top management change, level of firm resources, severity of decline, and level of industry growth. There have been efforts to find the relationship of decline with innovation to justify the proverb "necessity is the mother of invention." The study by Mone *et al,* (1998) indicates that innovation reduces (thus the intensity of "k" type turnaround process) with institutionalization of organizational mission, diffused power structure, lack of slack, and attribution that decline is uncontrollable and temporary.

There has been different arguments on asset retrenchment efforts in the turnaround process. It is perceived as an essential activity to ease the cash flow problems in the initial stages of turnaround efforts (Robbins and Pearce, 1992). Barker and Mone (1994) are of the view that this may not be always true. Cases from Khandwalla (1992) indicate that organizations may even expand their activity in the turnaround process or the retrenchment may be of insignificant order.

There have been some efforts to understand the relationship between turnaround efforts and social environment (Khandawalla, 1992). In an environment characterized by high rate of unemployment, legal barriers to retrench people and competitive industrial relations organizations may not gain significant result by people's retrenchment efforts. Under such conditions, other human resource interventions like redeployment and training would be appropriate. For example, Hong Kong-based Cathay Pacific airline resorted to layoffs and sacked about 800 employees last year. In the same year, Air India resorted to other schemes like three-year holiday without pay, voluntary pay-cuts, three-day week pattern, and reduction in wages. Air India did not resort to layoff due to prevailing legal barriers in the country.

Domain change would be an effective action in case of reduced munificence in the environment. For example, there is change in preference of people from scooters to motorcycles and small cars in the automobile market in India. Under such conditions, Bajaj Auto Ltd., a leader in scooters market in India, has little choice but to change the domain of its activities. Similarly, GCIL could be turned around only after a shift of its focus from gramophone discs to cassette.

Decline of the organization due to other factors may necessitate domain change. However, in organizations characterized by narrow core competence like air travel, it may be difficult to resort to domain change. Under such conditions, domain expansion or domain contraction could be a useful choice for such organizations.

The outcome of turnaround effort could be either revival or further decline of the organization. This would depend on the fit between environmental factors, organizational factors, and turnaround strategy. Wrong actions can lead to crisis finally culminating into closure. The probability of failure increases with cumulative changes in the strategic orientation (Kelly and Amburgy, 1991). This is because hazardous effects of core feature change may increase with repeated exposure to such changes.

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