CORPORATE GOVERNANCE IN THE AIRLINE INDUSTRY - EVIDENCE FROM THE ASIA-PACIFIC REGION

Geeta Duppati*, Frank Scrimgeour*, Rikkie Stevenson*

* University of Waikato, Private Bag 3105 Hamilton, New Zealand

Abstract

Globally airline performance has been variable with poor performance undermining the confidence of travelers, investors, Governments and other stakeholders. Airline corporate governance is a key determinant of airline performance. However, the relationships between governance and performance is complicated by the diversity of governance arrangements surrounding airlines. This study utilizes the four level model of Scrimgeour and Duppati (2014) to analyze the strengths and weaknesses of airline governance in the Asia Pacific region. Data from firm performance and firm behavior are analyzed for a 14-year period given governance and business choices occur at all stages of the business cycle and governance decisions have impact over multiple periods. Improving trust in the airline industry requires attention to all four levels of governance in a manner consistent with national and international business contexts.

Keywords: Corporate Governance, Airline Industry, Asia-Pacific Region

1. INTRODUCTION AND PREVIOUS LITERATURE

Recently, Indian Prime Minister Office asked for a detailed explanation from the Ministry of Aviation concerning the performance of Air India and restructuring plans[31]. Such concern is not surprising given the importance of aviation to national economies and the poor financial performance of Air India. In the decade to 31 March 2013 Air India made losses in all but 2007-13 years and accumulated operating losses totaling USD $ 4828.098 Million.

The size of these losses is significant given in aggregate they are larger more than the 2012/13 CAPEX budget of 11 individual states: Chhattisgarh, Goa, Haryana, Jharkhand, Kerala, Odhisa, Punjab, Rajasthan, West Bengal (closer), Arunachal Pradesh, Himachal Pradesh, Manipur, Nagaland, Sikkim, and Tripura[32] (Reserve Bank of India Annual publication, 2014).

Answering Prime Minister Modi's question requires careful consideration of Air India's recent history and operating context. The airline industry is notoriously competitive and subject to the vagaries of fluctuating demand, fluctuating oil prices and political uncertainty. The challenges are compounded by the high levels of unionism, the importance of maintenance to the sector, and the opportunities associated with ongoing technological advance. However, high quality governance and management within the best airlines sustains their success despite the challenges they face. Hence this study focuses on a set of airlines with variable levels of success and examines the impact of governance on performance.

The research focuses on five prominent airlines from the Asia-Pacific region: Air India, Air New Zealand, Garuda Indonesia, Qantas, and Singapore Airlines. The five airlines have significance as national carriers in their respective countries and are diverse in their ownership models, performance and governance systems. The study focuses on airline corporate governance and financial performance for a ten year period given governance and business choices occur at all stages of the business cycle and governance decisions have impact over multiple time periods.

Public consideration of airlines often focuses on questions such as why some airlines are prospering (Air New Zealand in 2014) when others are struggling (Qantas in 2014)? How to achieve high levels of performance with State Owned airlines? And how to fund national carriers when they accumulate losses. Rather than seek to directly answer these question this paper first seeks to understand both how airlines have performed in recent years and how they have been governed.

Given examples of governance failure across the global economy and high profile business failures in the Airline industry (Kingfisher airlines, Spice jet), it is appropriate to focus on the role of boards in ensuring organizational success and integrity. The boards of airline companies have a very crucial role as they address financial as well as social objectives while also dealing with the increased agency costs associated with government ownership and/or regulation.

[31] PMO seeks performance report from Air India, Financial Express, March 21st, 2015
[32] http://www.rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budgets

This paper adopts the four-layer agency model proposed by Scrimgeour and Duppati (2014). The majority of the studies in corporate governance are centred around the principal-agent relationships and principal-principal agency relationships. However, the consideration given to the institutional and contextual framework is minimal (Globerman, Peng, and Shapiro,2011; Aguilera, Filatotchev, Gospel, & Jackson, 2008; Fligstein, 2001). Likewise, the economic, social and political conditions vary by country, and a more subtle understanding of how these factors are continuously shaping the business environment is critical to spotting new opportunities and managing 3 unexpected risks. Therefore, the present study takes a holistic approach and sees if the corporate governance framework differs in different settings.

Earlier literature is stunted in comparing board dynamics under different ownership models. A review of extant literature explicitly referring to boards and strategy dates back to the beginning of the 1970s with a specific attention on the practical needs of US business community and accountability of boards and governance issues following the corporate failures and scandals (Vance, 1979; Lorsch , 1986). A shift towards non-US setting in the literature is evident from 2001 onwards and the majority of the studies referred to agency theory (Amedeo Pugliese et al., 2009).

At the same time, strategy started to become established as a research field (Volberda and Elfring, 2001), fuelled by major changes in the business environment of most Western countries (i.e., the increase in Japanese competition and the oil crisis) (Pettigrew, Thomas and Whittington, 2002). During this first period, research on boards and strategy was characterized by a debate on the desirability of active board involvement, in the realm of strategy. This discussion followed an ongoing US debate around a perceived passivity of boards of directors at that time (Herman, 1981; Stiles and Taylor, 2002). A shift towards non-US settings is evident from 2001 onwards. While early studies mainly discussed the desirability of board's strategic involvement a more recent line of research posits boards as decision-making groups whose internal processes and external context should be better understood (e.g., Forbes and Milliken, 1999; McNulty and Pettigrew, 1999; Huse, 2005; Ravasi and Zattoni, 2006).

Further, Amedeo Pugliese et al (2009), emphasized, the need to understand the role of context at multiple levels as most of the contemporary wisdom originates from US samples of large public companies; and as comparative corporate governance studies are sparse. As a result, the impact of the national setting (e.g., the legal system, culture, and economic conditions) and firm characteristics (e.g., the ownership structure, board structure, firm performance, and life-cycle) on the relationship between boards and strategy is not fully understood (Aguilera and Cuervo-Cazurra, 2004; Ravasi and Zattoni, 2006; Hambrick, v. Werder and Zajac, 2008).

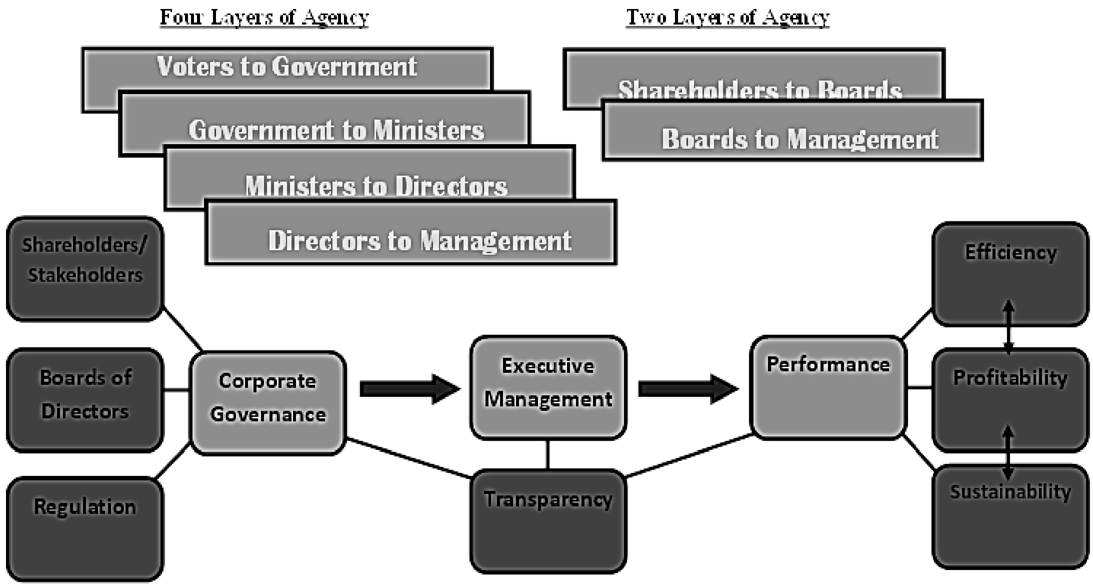
The studies largely discussed the board's role and corporate strategy and performance from the perspective of private ownership model. In spite of the growing focus of research on boards of directors, there is still limited evidence on the antecedents of the board's behavior in different national settings under different ownership models. It is evident from the four layer model and two layer model presented in Figure 1 that the agency issues could differ under the two ownership models. This paper therefore, fills the lacuna in the research. This paper beliefs that the degree of influence the board of directors have on corporate strategy and subsequently the performance differs between state-owned enterprises, mixed-ownership companies and privately owned companies. The views expressed by Andrei Shleifer, 1998 in favour of private ownership over government ownership, are in support of the present research which decomposes the conventional agency theory model of private ownership into a four layer agency model in order to suit the context of SOEs.

2. METHODOLOGY

The present study approaches the issues of corporate governance and performance by utilizing theoretical framework as shown in the Figure 2. It is evident from the Figure 1 that the important influencers in the corporate governance include: Shareholders, stakeholders, Board of Directors and Regulators. The strategy of the corporate is decided at layer 2 and 3 in the case of SOEs (four layer model) and in layer 1 of the two layer agency model as shown in Figure 1. The strategies that are set up are implemented by the executive management (CEO/Managing director) and who in turn ensures that performance is driven by efficiency and productivity to attain profitability which when contained for a longer periods will result in corporate sustainability.

The research involved five steps: Measuring financial performance; Characterisation of airline governance; Identification of airline "problems"; Linking of "problems" with governance characteristics; and interpreting the findings in the light airline performance and corporate governance more generally. The component of level of disclosure is assessed based on the trends in return on assets (ROA). The peaks and troughs of each airline are chosen and analyzed. ROA is the widely used metric to measure profitability, and is expressed as net income divided by total fixed assets. This ratio reflects the ability of firms to generate income from using assets (Locke & Duppati, 2014, Abor, 2005; Bistrova et al., 2011).

Figure 1. The two layer agency model



3. FINDINGS

It is evident from the graph below that the ROA declines for all the five airlines in 2006 and subsequently increases and has peaks for the four airlines Air New Zealand, Qantas, Garuda Indonesia and Singapore airlines in the year 2008 with the exception of Air India in which case the ROA declines sharply. Further in the year 2010 the ROA of all the airlines is on decline. Air India shows a rebound towards year 2014 while the ROA of Qantas falls sharply. It is therefore, evident from the Figure 2 that the year 2006, 2008, 2010 and 2013 are striking in terms of peaks and drops. The changes in the ROA are analyzed and interpreted based on the governance and strategy of the five airlines from the annual reports and public commentaries on the sector and presented as follows:

Table 1. Summary statistics of performance indicators for the five airlines

			Return On Assets		
	AIR NZ	*QANTAS*	*AIR INDIA*	*SINGAPORE*	*GARUDA*
Mean	0.044	0.015	-0.091	0.046	0.061
Minimum	0.021	-0.141	-0.181	0.011	0.025
Maximum	0.070	0.057	0.020	0.091	0.097
			Net Cash From Operating Activities		
	AIR NZ (NZD)	*QANTAS*	*AIR INDIA*	*SINGAPORE*	*GARUDA*
Mean	509.6	1700.3	-36667.1	2616.8	2178666.4
Minimum	167.0	1035.0	-88658.9	1777.4	1279173.0
Maximum	750.0	2353.4	-213.7	4418.9	4893426.1
			Debt To Total Assets		
	AIR NZ	*QANTAS*	*AIR INDIA*	*SINGAPORE*	*GARUDA*
Mean	0.677	0.712	1.074	0.406	0.750
Minimum	0.623	0.668	0.803	0.388	0.539
Maximum	0.703	0.829	1.385	0.418	1.103

Note: Cash from Operating activities is expressed in local currency

Table 2. Details of Boards and Ownership structures

	Air New Zealand	*Air India*	*Qantas*	*Garuda*	*Singapore*
Board Size	8	12	9	5 commissioners, 8 directors	9
Board Composition	All directors are independent	Mostly exec	All independent directors except for CEO who is on the board	3/5 independent commissioners.	All independent apart from the CEO
CEO Duality	No	Yes	No, but CEO is on the board	Yes	No, but CEO is on the board
Director Qualifications	Some masters degrees but mainly just bachelors	Split between bachelors and masters.	Most have masters degrees or equivalent	Mostly masters degrees in business and engineering	Qualifications not disclosed

	Air New Zealand	Air India	Qantas	Garuda	Singapore
No of females	2/8	2/11	3/9	1/5 for commissioners, 0 for directors	1/9
Remuneration of board	Chairman 230k, director 90k, CEO 625k + STI + LTI	Remuneration of directors and CEO not disclosed	CEO 2m base +STI + LTI, Chairman 560k, Member 144k	2,409,614 USD for all directors combined, 682,464 USD for all commissioners combined	Chairman 265 SGD, Director 155 SGD, CEO 1.094million + bonuses and incentives
# of committees	3 committees, Audit, Remuneration and diversity, Safety Committee	3 committees - Audit, Remuneration, Sustainable development committee	4 committees – Audit, Remuneration, Safety, Nomination	2 commitees- Audit committee and Business development and risk committee	5 committees, Audit, Executive, Compensation, Nomination, Safety and risk
# of other directorships	49, variety of companies	ED's also directors of subsidiaries. NED's are government directors. ID's have many other directorships	30, variety of companies	Directors are in charge of day-to-day running so do not have other responsibilities, Commissioners	84
Ownership structure	Mixed Ownership model. Government owns 52%	State Owned Enterprise	Fully privatised, publicly traded	Mixed ownership model	Mixed Ownership model
Age of company		Formed 2007 from merger			
Political affiliation	No major political affiliation from any of the board members	Two directors from the ministry of civil aviation	No political delegates or affiliation	2 commissioners affiliated to government, ministry of transportation	No political affiliation of directors
Term Length	3	3	3	3	3
No of meetings	No meeting information shown	7 per year	11 meetings	11 meetings for directors, 9 meetings for commissioners	4 board meetings and 6 board executive committee board meetings
Ethics statement	High level of ethics expected of board	Not a strong statement of the ethical expectations of the BOD.	High level of ethics explained and expected from directors.	Thorough explanation of the roles and responsibilities of both the commissioners and directors. Implemented their "Good Corporate Governance" policy in 2013	No specific ethics statement but there is emphasis on accountability, audit and whistle blowing.
Sustainability/CSR statement	Aim to become one of the most sustainable airlines. Use of efficient planes and environmental initiatives **Self-driven**	Sustainable development committee is set up but no real discussion on how they are working on sustainability **Compliance**	Promotes sustainability but not overly emphasized in the annual report **Self-driven**	Section in annual report dedicated to CSR, multiple CSR corporate initiatives **Self-driven**	Dedicated environment section explaining their commitment to sustainability and their initiatives **Self-driven**
Transparency					
Level of Disclosure	High Level of disclosure – Includes ethical policies, board info, diversity policies, director profiles and interests, reasons for not following NZX code, role of the board.	Moderate disclosure – sticks to guidelines.	Very High Disclosure – Most things covered and discussed	Extremely high disclosure – much beyond what is required	High level of disclosure. Statement in annual report of their commitment to going beyond just the legal requirements

The challenges that are common to airlines in general include: to economic and capital market volatilities following the global economic crisis, the currency fluctuations against the American dollar, increasing fuel prices, competition at both the regional and domestic levels has become more intense, with more sluggish passenger activity caused by actions of foreign and local airlines.

Figure 2. Return on assets trends

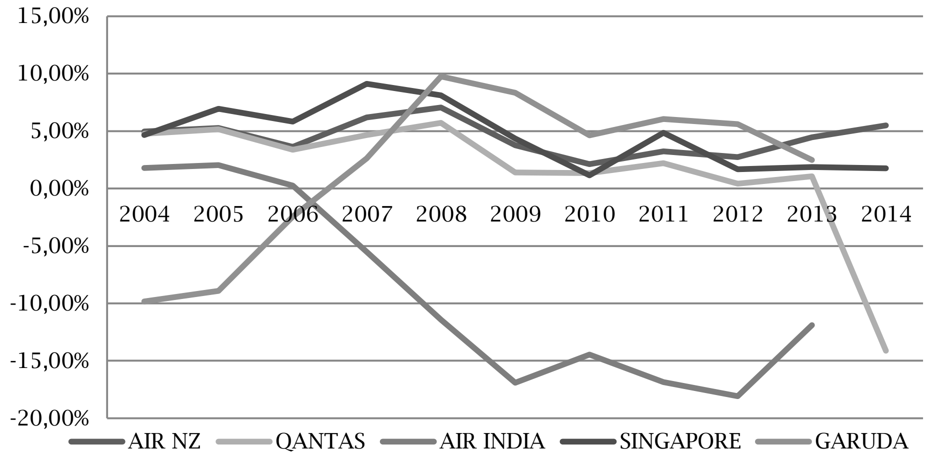
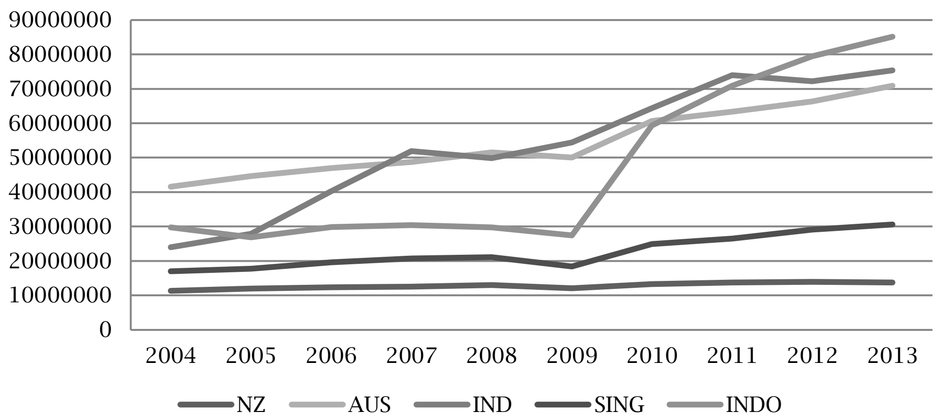


Figure 3. Air passenger numbers by country



Garuda airlines

Garuda Indonesia overcomes the challenges because of the stronger foundation and long term strategy in place. In order to moderate the currency fluctuations issue the Airlines had come up with debt restructuring programmer and to combat the fuel price increase it focused on fuel conservation program. Following the successful establishment of a strong foundation, Garuda Indonesia embarked on the Turnaround phase in 2008, in line with the Strategic Plan 2006-2010. This phase is focused on service improvement supported by the enhancement of financial and organizational structures. The "Power 8" program that was introduced by the Company to emphasize the product and service improvements, particularly improvements to the product structure, new concept marketing program, service quality, flight comfort and safety, debt restructuring, and the preparations of company privatization. Through the program, Garuda Indonesia made improvements in its financial, operational and management practices. 2008 concluded with very satisfactory growth in consolidated net income, from Rp 60.18 billion in 2007 to Rp 669.47 billion.

Singapore airlines

The performance of Singapore airlines has been mostly consistent and positive. It had issues of fall in demand across all cabin classes fuel price hikes and losses from pre-purchased fuel hedges in the short term. Nonetheless, it's prudent and conservative strategy on fuel hedging enabled it to offset the losses on hedging with gains against the budget price for fuel that were not hedged, when the prices fell. It is grounded on its core values and principles which had been adhered throughout its history, and commitment to these principles puts in a stronger position over their competitors. Their fundamental values include: First, reliance on living within their means, not exposing themselves to any meaningful level of debt and maintaining sufficient reserves to help cushion the business in the times of uncertainties. It resisted the temptation to opportunistically gamble heavily on fuel and currency hedges, preferring a consistent approach through good times and bad.

To contain costs, it reduced the size of the operating fleet, which brought down costs. There are difficult flow-on effects of these decisions: It considers human resource investment as vital and this approach enables it to have cordial relations with the unions which enables it to smoothly navigate its way through the crisis. The strong line of products and services offered that appeals to customers. They include a young and modern fleet led by the very popular Airbus A380, and with the arrival of the new Airbus A330s for medium-haul and regional routes. Towards recognizing its loyal customers, It pursues business with more dynamic pricing, exceptional value-added packages and promotions designed to recognize our loyal customers. These offers will continue, so that we maximize the potential to fill seats.

Qantas

Qantas airlines performance had been declining gradually since 2008-09 onwards and experienced a steep decline in 2014. The chairman indicated that the Qantas airlines are in transformation for a better and stronger airline. According to the Chairman, the Qantas Transformation program of 2011/2012 delivered substantial strategic benefits in 2012/2013. The airlines withdrew from loss-making routes, retired aircraft, consolidated operations and improved the economics of the fleet. Overall, the airlines experienced a reduction in the Group-wide comparable unit costs by 5 per cent (including a 5 per cent reduction for Qantas International). The Group's fleet modernization program is in place to improve the customer experience and increase operational efficiency.

Further, the explanations of the Qantas Group after reporting an underlying PBT loss of $646 million for the financial year ended 30 June 2014 were as follows: Weak underlying demand growth in Australia, with consumer spending and business confidence remaining subdued; $566 million of yield and load factor decline from market capacity growth running ahead of demand and $253 million higher fuel expense, driven by the weaker Australian dollar. The Group took decisive action to address these challenges, commencing the accelerated Qantas Transformation program on 1 January 2014. This program is targeting the delivery $2 billion of benefits by the end of financial year 2016/2017.

The issues of unionism are intense in Qantas and it is likely that any attempts made towards restructuring are resisted by the unions. Labor party is keen to defend the ownership limits and warned against the threat to national security and the Australian economy from the loss of the airline[33].

Air India

It is evident from the figure that its ROA declined since 2007 and remained negative since then. The period 2007 had been a strategic year because the decision of merging erstwhile Indian airlines Ltd. was made effective 27 August 2007. Consequently, the entire shareholding of the company is now held by Indian Airlines Ltd. Unlike other airlines considered in the study, Air India does not discuss the issues that lead to low performance.

[33] Abbott's problem: Labor wants to save Qantas unions, not Qantas:http://blogs.news.com.au/heraldsun/andrewbolt/index.php/heraldsun/comments/labor_wants_to_save_qantas_unions_not_qantas/

Does the passive approach of the Boards and the Aviation Ministry support the views of Andrei Shleifer (1998) which are stated as: since politicians typically like to remain in power and enjoy the perquisites of their office, a significant element of the goals of any government is to maintain political support. In democracies, such political support usually takes the form of votes, though less democratic governments also need loyalists who can provide manpower to suppress the potential opposition. Governments throughout the world have long directed benefits to their political supporters, whether in the form of jobs at above-market wages or outright transfers. Governments have used their control of state firms and other assets as a means of channeling these benefits, by forcing excess employment at state firms and agencies, creating government projects that transfer wealth to supporters, and so on. In other words, state firms are inefficient not just because their managers have weak incentives to reduce costs, but because inefficiency is the result of the government's deliberate policy to transfer resources to supporters (Shleifer and Vishny, 1994, 1998; Bennedsen, 1998).

Air New Zealand

It is evident from the figure below that the performance of Air New Zealand had been gradual. Its continued focus on relationships on airline customers brought them success. Despite the ongoing turbulence in the current economic environment, Air New Zealand continues to grow its reputation as a clever, adaptive and innovative company, delivering an outstanding service domestically whilst capitalizing on its inherent talents by exporting New Zealand innovation to the world. It is also engaged in developing and providing air navigation solutions in a wide number of industry areas – including airspace capacity, operational efficiency, safety and the environment.

It has adopted Collaborative decision to ensure that aircraft operations are optimized to reduce fuel burn and eliminate delays. It recognizes that without such collaboration the result will always be sub-optimal. For instance, the outcome of the collaboration of the Federal Aviation Administration (FAA) of the United States and Air services Australia, under the ASPIRE banner (Asia and South Pacific Initiative to Reduce Emissions) enabled an Air New Zealand Boeing 777 to fly the most efficient route possible between Auckland and San Francisco.

The three corner stones of Air New Zealand include: the need to respond quickly and efficiently to the changed economic conditions which challenge the ANS industry's cost recovery model; the need to prepare for the future by delivering on the range of opportunities contained in the Vision 2015 programmer; opportunities that brings long term benefits to the airline customers in terms of reduced fuel consumption and emissions, and the need to focus Airways' growth businesses on Airways core competencies of ATC training and ANS systems expertise.

4. CONCLUSION

Garuda had a restructuring plan for 2006-2010 but the turnaround occurred much earlier and the performance reached its peak in 2008. The restructuring strategies included: Financial Restructuring, Balance Sheet Restructuring, Organizational and Human Capital Restructuring, Aircraft Reliability and Safety, Comfort, Service Quality Improvement, New Concept and Improvement in Marketing Program and Image Recovery. This is indicative of boards that are performing. The conservative strategy of Singapore airlines in offsetting the shortcomings of hedging through reasonable price for fuel that were not hedged is indicative of proactive approach of the boards. The approach of the Boards of Qantas has been reactive than proactive as the introspection into the operations and restructuring was undertaken only after incurring huge losses. The result reflects the very difficult operating environment the Group has faced; Although Qantas is held by private investors still it has issues of underperformance and this could be due to protection laws of labour unions and the protective role played by the labor party in preventing any layoffs as a part of restructuring programmer. The Air New Zealand is conscious about the strategies of making a successful business. In the case of Air India neither the chairman nor the ministry identified any issues or specific reasons of non-performance other than the general limitations and challenges that prevail in the sector. This is indicative of the passive approach of boards and also the governing ministry. This indicates that there are agency issues in the second and third layers. The issues of Air India are in line with the issues of Indian SOEs identified by Scrimgeour and Duppati (2014) and views of Shleifer and Vishny, (1994) on government ownership. Inspite of being a drain on the public resources (treasury) the government is not serious about restructuring plan or divesting. The findings of Singapore airlines are in line with Chen (2013) who stated that Temasek's success is not necessarily a result of law, but may have more to do with its self-disciplinary nature and the hands-off approach of the Singaporean government. This means that the Temasek model may not easily be copied by state-owned enterprises in other countries. However, the fact that Temasek plays like an active investor and complies with corporate law may prove that state owned enterprises may still enjoy a higher quality of corporate governance, and that sovereign wealth funds may behave akin to responsible investors. Singapore airlines, Garuda Indonesia and Air New Zealand are governing and managing with a commercial objective and hence have viable and realistic strategies in place.

Although the ownership models in the cases of Air New Zealand, Garuda Indonesia and Singapore are the same, but the way the portfolios are held differs. In the cases of Air New Zealand and Garuda Indonesia government shareholding of 52% and 62% held by the Ministry of Finance, while in the case of Singapore Airlines the 62% of the government shareholding is held by Tamesek holdings pte ltd which is its sovereign wealth fund. In all the three cases the government shareholding is considered as an investment portfolio and this indicates the government using these corporates as investment vehicles. In contrast, the case of Air India government as the only shareholder struggles to demonstrate optimal social or commercial performance. The case of India has issues of corporate governance and agency conflicts are prevalent in the second, third and fourth layer which is more pronounced in the performance, lack of strategy or initiation and poor accountability.

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