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From the Editor

The financial crisis became a global event that, at the printing of this issue (July 2012), seems to have resulted in another period of slowing growth worldwide. In the last few years the causes of the crisis were examined and reexamined, and the depressed economic climate has influenced political establishments globally. Politicians are likely to be voted out of office as the unemployed exercise their dissatisfaction, and in countries with multiple political parties capitalism will experience serious challenges.

In this time period it is sometime difficult to focus on scholarly research, since typical papers address specific issues often not necessarily global in scope. Yet a house is built brick by brick, and resolving issues, even though they appear small in the global arena, contribute toward understanding policies that would positively contribute to the workings of the capitalist system.

In this issue of our Journal, Amalia Magán-Díaz and José Céspedes-Lorente in “Why are Spanish Companies Implementing Downsizing?” are hinting that it may improve performance, and considering the 20% unemployment in Spain at the present time, this topic is an item that deserves notice. St. John’s faculty I. Hilmi Elifoglu, Adrian Fitzsimons, and Benjamin Silliman are concerned with a larger picture in “Separate Financial Reporting Standards and Standard Setting for Private Companies,” due to the urgent and growing systemic issues with respect to private companies’ financial statements. Saira Latif and Yi Yang rightly question market efficiency in “Do Investors Care about Earnings Management?” One would think they do, but some items remain obscure and deserve more transparency.

In today’s business environment much discussion is aimed at regulation in general. Katherine Barker, Carl Pacini, and Dave Sinason in “The Foreign Corrupt Practices Act: A Law Worth Revisiting” show that compliance is not always followed, creating a dangerous situation for firms. Most people who study regulation would agree that the best practice with respect to any regulation is to revisit it and make changes, if necessary, as when rules are being drafted no one can perfectly foresee all the possible impacts a regulation can have. Continuing with regulatory issues and specifically related to Dodd-Frank Wall Street reform, Thomas A. Hemphill updates us in “The U.S. Shareholder Say-on-pay Vote: What are the First Year results?” Robert F. Salvino revives the discussion of the real estate crisis and takes

Beena George and Faiza Khoja focused on social benefits of businesses in “Doing Good and Making Profits: A Case Study of Affordable Business Solutions.” John Malindretos, together with colleagues Augustine C. Arize, Peter Harris, Krishna M. Kasibhatla, and Moschos Scoullis, tests the stability of money demand by a co-integration technique in “The Values of the Determinants and Tests of Stability of the Money Demand Function of the United States.”

Igor M. Tomic, Ph.D.
Editor, Review of Business
Why Are Spanish Companies Implementing Downsizing?

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Executive Summary

The widespread implementation of downsizing and its repercussions at company level and the national (or even global) economy make it a topic of major relevance for study. The question researchers normally ask is “Why do organizations continue to implement downsizing if, on many occasions, it has been shown to have a negative effect on performance?” The main aim of our research is to propose a causal model for the downsizing practised by Spanish manufacturing firms during the 1990s. Our time period is some 15 years after Spain’s entry into the European Community (EC) and the tentative introduction of the neo-liberal logic of labor relations. Basically, this model analyzes the institutional determinants of downsizing, but its integral nature also allows the inclusion of different – mainly economic – causal factors. Its main focus is the analysis of how organizations imitate one another in implementing downsizing practices, presumably in a quest for legitimacy and efficacy. We provide new empirical evidence in addition to the rather scarce existing literature that analyzes the causes of downsizing from an institutional point of view.

Our results provide some useful implications for practice. Mainly, the diffusion of some management practices, such as downsizing, follows the pattern of a ‘firm fashion.’ These fashions spread among the company population without clear evidence about their positive influence on results. Our study shows that the imitation effect is important to explain companies’ adoption of downsizing. Firms should cautiously assess the convenience of implementing these practices. Managers should be aware of the reasons that lead them to downsize.

Introduction

The last two decades of the 20th century have seen the emergence of a business phenomenon that is characterized by reducing the permanent workforce, often combined with a restructuring scheme. The most common term used to describe this phenomenon is downsizing.

Downsizing has been directly responsible for major layoffs in the business sector. For example, in the U.S. economy, an estimated ten million jobs have been lost due to this phenomenon between 1979 and 1999 (Budros 1999). Now, as we move into the 21st century, these workforce reductions are of even greater relevance in Western economies (mainly U.S.A. and Europe), and are now developing in countries that are relative newcomers to global competition. These include Russia, Ukraine and Belarus (Filatotchev et al. 2000). Downsizing measures are even becoming commonplace

The authors acknowledge the financial support from the Spanish Ministry of Science and Innovation, and FEDER (Project ECO2011-24921).
in countries that have a strong tradition of employment protection, like Japan (Ahmadjian and Robinson 2001). Spanish companies are no exception to the downsizing tendency, as staff cutbacks in the last two decades of the 20th century clearly show (Suárez 1999; Requejo 1996; Barroso and Casillas 1998; Suárez and Vicente 2000; Sánchez and Suárez 2003; Vicente y Suárez, 2007). Specifically, in 1989 to 1994, almost 50% of large Spanish companies resorted to downsizing, with an average reduction in personnel of 31% (Suárez 1999). Furthermore, analysis of layoffs announced in the economic journals Expansión and Cinco Días between 1995 and 2001 shows that such measures were taken by 281 companies (Sánchez and Suárez 2003), 45 of which made cuts to the permanent workforce on more than one occasion (Telefónica, Banesto, Iberia, Endesa, Astilleros Españoles, BSCH, etc.).

There is...evidence of a positive effect of downsizing on firm productivity in the biggest Spanish companies, but only in the short term.

As we can see, the widespread implementation of this phenomenon, and its repercussions on both company level and the national or even global economy, make it a topic of major relevance for study and analysis from different points of view.

Although downsizing has attracted the attention of numerous researchers, the literature on this subject is relatively new, since the majority of existing studies were published in the early days after downsizing started to gain in popularity.

Most definitions of the phenomenon of downsizing assume it is applied as a measure to improve an organization’s results (Freeman and Cameron, 1993; Cameron, 1994; McKinley et al. 1998). This assumption has been analyzed widely in relevant literature and has focused on the effects attributed to this practice. Various studies have reported positive effects of downsizing on organizational performance (Espahbodi, John and Vasudevan, 2000; Baumol, Blinder and Wolff, 2003; Wayhan and Werner, 2000).

Other studies have shown that reduced productivity following downsizing may be counterbalanced by savings in personnel costs (Baumol et al., 2003; Cappelli, 2000). In the biggest Spanish companies, there is evidence of a positive effect of downsizing on firm productivity. However, this only seems to be the case in the short term (Barroso and Casillas, 1998). This conclusion is consistent with other studies (Cascio et al., 1997; Morris, Cascio and Young, 1999). However, although some firms could improve their performance during the year or two following the implementation of downsizing, this positive trend changes, and they begin to experience performance reductions thereafter. Porter (1996) offers an explanation to this evidence by considering downsizing as a strategy towards economic efficiency, but one that cannot produce a competitive advantage in the long term, as other companies may follow suit, thereby maintaining a status quo.

After more than a decade attracting the attention of academics, and despite greater knowledge now available on the subject, published studies on the question are inconclusive as to the relationship between downsizing and variations in organizational performance (Guthrie and Datta, 2008). Nevertheless, the majority of the studies seem to suggest that the impact of downsizing is negative in the medium and long term (Palmon, Sun y Tang, 1997, Trevor y Nyberg, 2008).

Given this controversy, the question researchers now ask is: Why do organizations continue to implement downsizing measures if on many occasions they have been shown to have a negative effect on economic performance?
Several recent theoretical and empirical works have attempted to answer this question by analyzing the causes of this phenomenon, using different theoretical frameworks (McKinley et al. 2000).

First, they adopted a rational focus, under the premise that organizations downsize in order to improve efficiency (McKinley et al. 1998). Nevertheless, evidence that is inconsistent with the predictions of this approach has led to other research which looks at different theoretical perspectives, of which institutional theory has received the most attention. This focus allows us to consider the social processes present in the organizational field as determiners of downsizing, instead of the organization’s economic interests. This research supposes that society considers downsizing a kind of institutional norm, and so organizations are motivated to adopt such practices in order to achieve a kind of legitimacy in their field. This behavior, according to neo-institutionalist literature, implies the aim of efficacy, as opposed to efficiency. However, new contributions to institutional theory have led researchers to contemplate, among other aspects, the compatibility of both motivations. This implies that organizations make decisions influenced by social pressure, but without neglecting their own interest (Dacin et al. 2002).

In fact, empirical evidence exists that shows the inability of any of these approaches (mainly the economic-rational and the institutional) to explain this phenomenon on their own (Mentzer 1996). This has led to the proposal of integrating causal models, combining different explanatory factors (Budros 1999; Sánchez and Suárez 2002; Vicente and Suárez, 2007). However, they do not put forward a single theoretical framework including all of the explanatory factors.

The main aim of this research work is to propose a causal model for the downsizing practised by Spanish firms (that are not leaders in their industry) during most of the 1990s. Our time period is some 15 years after Spain’s entry into the EC and the initial, tentative introduction of the neo-liberal logic of labor relations. Although it would be preferable to track downsizing behavior from the late 1980s – but especially after the 1992 law reform – our study considers the period 1994 to 2000, due to the availability of data. We refer to non-leader firms because we made the supposition that the institutional factors can affect leaders and followers in different ways. For example, the ‘followers’ can implement downsizing following such measures taken by leaders. However, the leaders use market logic prevailing in an international level in implementing these measures.

Basically, this model analyzes the institutional determinants of downsizing, but its integral nature also allows the inclusion of different types of causal factors, mainly economic ones. Its main contribution, therefore, is the analysis of the way in which the quest for legitimacy and efficacy leads organizations to imitate one another in implementing downsizing. New evidence is provided to add to the scarce empirical literature analyzing the causes of downsizing from an institutional point of view.

The Spanish Setting

The economic crisis of the early 1990s, particularly in 1992-3, saw a greater loss of employment than previous crises. However, it was also shorter, and by mid-1994 employment was starting to recover. This scenario can be explained by several factors.
First, Spain was by then much more integrated into the European economy, which meant that an international recession was transferred to the Spanish economy much faster than before. However, the great loss of employment in the industrial sector registered in 1992-3 implies a process of structural readjustment of the economy. Recio (1999) points out that during the last employment crisis (1991 to 1994) stable jobs suffered more than temporary ones, since this crisis had a greater effect on those activities with predominantly stable employment (e.g. shutdowns, staff adjustments). Loss of employment was particularly high in the agricultural and industrial sectors, which suggests that the adjustment process actually involved the substitution of permanent positions with temporary ones, with a marked increase of the latter in the services sector.

Another reason for the high number of layoffs in Spanish companies, especially in 1993, is the reform introduced in 1992. This reform made it impossible to extend temporary contracts once they had terminated, meaning that these workers either had to become permanent members of staff or be made redundant.

It was the adjustment of the Spanish economy (together with the strong position of the peseta following the fall of the communist regimes of Eastern Europe) that goes some way to explaining this crisis. It meant a second process of industrial reconversion which was more intense but also shorter than the one which took place in the early 1980's (Toharia et al., 1998). The devaluation of the peseta in 1992-3 helped to return competitiveness to the 1985 level, thus facilitiating swift economic recovery.

The inefficiency in the labor market led the government to adopt a reform in late 1993 with the basic aim of promoting collective bargaining and avoiding aspects such as redundancy costs. Two of the changes introduced in this reform merit special attention: the reform of contracts and the changes in redundancy procedures. Considering reform, the main change was to eliminate temporary contracts to promote growth of permanent employment except in specific cases of certain groups of workers. Although this measure was intended to encourage permanent employment, in fact companies have found other modes of temporary employment that are even cheaper than the one that was eliminated.

...the behavior most emulated by organizations is that which has allowed other organizations to be successful.

Considering redundancy costs, the new policy attempted to reduce them, mainly by introducing “objective redundancies”, a concept that allows companies the right to lay off workers with reduced redundancy payouts. However, this innovation has not changed the overall situation to any great extent. As neither the use of temporary contracts nor redundancy costs had been reduced, a new reform took place in 1997 (after the arrival of a new government in 1996). The most significant innovation introduced in this legislation was the creation of a new type of indefinite contract to encourage employment but that involves lower redundancy costs. In this way, indefinite employment is encouraged in exchange for more flexibility when it comes to terminating contracts. More labor reforms came along in 1998 and 1999, all of which intended to combine flexibility with protection.

Theory and Hypotheses

Institutional theory has been chosen for this research since it is an alternative perspective to the rational focus in the construction of a causal model for downsizing. As it has proved impossible to demonstrate that organizations put downsizing into practice in order to be more efficient, this new theoretical framework considers that the prime motives are to
obtain legitimacy in the industry sector and to be accepted irrespective of performance. The institutional perspective provides an explanation for the widespread adoption of downsizing among government bodies and agencies, mainly in the 1990s (McKinley et al. 1998). Its argument is centred on the fact that downsizing has obtained the status of an institutional norm, and as such it provides legitimacy to those organizations that practise it. This legitimation is based on the reconceptualisation of the term downsizing, i.e. as being no longer (necessarily) linked to the idea of decline. The empirical evidence provided by the literature indicates the acceptance and spreading of downsizing as a practice, and the fact that it is taken for granted due to the institutional environment (Budros 1997, 2000; Lamertz and Baum 1998; Dahl and Nesheim 1998; Filatotchev et al. 2000; Suárez 1999; Suárez and Vicente 2000; Sánchez and Suárez 2003; Sánchez and Suárez 2005).

Several other theoretical perspectives can be found in the literature analyzing the causes of downsizing, and there is no reason why these should be incompatible with one another. McKinley et al. (2000) also identify the economic-rational and the socio-cognitive ones. Later contributions to the literature approach the study of downsizing from other theoretical points of view, such as the resources and capabilities theory (Fisher and White 2000; Nixon et al. 2004) and the agency theory (Filatotchev et al. 2000).

Some articles in the literature of downsizing (Budros 1999; Love 2000; Sánchez and Suárez 2002) make use of the complementary nature of the different perspectives mentioned above.

For example, in the case of Spanish companies, the theoretical model of Sánchez and Suárez (2002) mainly uses the institutional perspective, although also highlighting its complement with the rational point of view. However, it is Suárez and Vicente (2000) who provide evidence on the complement between economic and institutional causal factors when explaining the downsizing phenomenon in Spanish companies. Sánchez and Suárez (2005) made an exploratory study of the justifications made by companies announcing downsizing measures in the press, although the adoption of a theoretical framework for the causal analysis of this phenomenon is still needed. In this sense, new research in the context of Spanish companies may shed more light on the reasons that lead to downsizing.

According to institutional theory, an organization obtains legitimation in the society in which it acts when it adopts in its structure and procedures certain patterns of action that are specified by said society (Scott 1995). These institutional forces are the reason why organizations that belong to the same organizational field become more and more alike, a process known as isomorphism (DiMaggio and Powell 1983). These institutional theories establish that similar organizations use each other as a framework of social reference. Indeed, the behavior most emulated by organizations is that which has allowed other organizations to be successful. This behavior is a function of ‘imitation’ or mimetic isomorphism. It follows that certain organizational forms or practices predominate in a given organizational field (Scott 1995).

When a growing number of organizations adopt a programme or policy, it becomes progressively institutionalized, or widely recognized as a necessary component of a rationalized organizational structure. The legitimacy of the procedures acts as an impetus for those who later adopt them (Tolbert and Zucker 1983). This process of organizational diffusion, known as the “contagion” model, considers that when an innovation arises, it is adopted by a small number of organizations, but once a critical threshold has been reached, it is quickly implemented by a wide range of agents (Hoffman 1997).
Fligstein (1985) reached similar conclusions in his study, interpreting the variable “number of organizations which adopt a given structure in the industry” as a measure of the mimetic pressure on the organization which leads it to imitate the practices of their competitors.

*Inter-organizational imitation* occurs when the use of a given practice by one or more organizations increases the likelihood that it may be adopted by other organizations. The empirical work of Haunschild and Miner (1997) distinguishes between three different types of selective inter-organizational imitation: imitation based on frequency (copying the most common practices), imitation based on characteristics (copying the practices of organizations of certain characteristics), and imitation according to results (imitation based on the impact which a given practice appears to have on others). The first two types are consistent with the theories that emphasize social processes, since the cause does not depend on whether these practices produce benefits. The third type, on the other hand, is more related to theories on technical processes.

Imitation based on frequency explains the behavior of those organizations that implement practices that have previously been used by a wide number of organizations. It is therefore coherent with the neo-institutional perspective, since it is the frequency itself that influences these acts.

This “adoption effect” can be associated with downsizing, supporting the prediction of Budros (1997), according to which the legitimization, or extent to which downsizing is “taken for granted”, is positively related to the indexes of downsizing. By “adoption effect” we understand the cumulative percentage of companies that have implemented downsizing practices.

Ahmadjan and Robinson (2001) also described the same relationship in their empirical work, calling it *Safety in Numbers*. These authors consider that as the number of organizations in a population practising downsizing increases, it seems likely that the social costs for each individual organization will decrease. The concept of “Safety in numbers” leads to the supposition that some organizations would follow the example of others in the population: the more organizations practising downsizing, the more likely any other organization is to follow suit. An alternative explanation to this effect is that the growing index of adoption of downsizing reflects the increasing legitimacy of taking such measures.

From these arguments we derive the first hypothesis here proposed, which considers the number of organizations that have previously applied downsizing as one of the explanatory variables for the implementation of downsizing practices. In this case, downsizing is being imitated using the criterion of frequency (Haunschild and Miner 1997); that is, its widespread adoption in the business environment.

**H1:** the implementation of downsizing measures is positively related to the number of cases of downsizing that have previously taken place in other companies.

A question arises at this juncture: which criteria and processes do organizations use to determine the limits of their field and the identity of their reference group? In response, Scott (1995) makes use of research by Haveman (1993), according to which organizations tend to imitate organizations that belong to their own population, which for the purposes of this work is the same as belonging to the same industry. As for the models chosen to be emulated, Haveman (1993) considers two possibilities: (1) organizations imitate others of a similar size, and (2) organizations imitate others which they consider more successful, in this case the most profitable and the largest ones. This argument states that there are organizational leaders who promote
innovation without interacting directly with their followers in the networks.

According to the theory of imitation based on characteristics, organizations use practices that have previously been used by a sub-group of organizations that have certain characteristics in common. Neo-institutional theorists (DiMaggio and Powell 1983) suggested that the characteristics that provided this sub-group with legitimacy were large size and success. These were also characteristics of high-status organizations, and by imitating them other organizations were able to acquire similar status (Fombrun and Shanley 1990).

Budros (1999) continues this logical idea, suggesting that downsizing is taken more for granted as more elite organizations start to put it into practice, producing a mimetic behavior pattern (both economically and socially) in those firms which do not belong to said elite.

This argument considers that those companies that share the common characteristic of being successful, reflected in the possession of a high status, are chosen by other companies as an example to follow. Moreover, this second type of imitation (based on characteristics) is identified by Haunschild and Miner (1997). This argument leads to the second hypothesis, which diagnoses a positive relationship between the implementation of downsizing by leading organizations in a sector, and the proliferation of the use of this practice among the remaining organizations in the sector (the followers).

**H2:** the implementation of downsizing measures by a company is positively related to the number of downsizings previously carried out by the leading companies in the given sector.

Finally, the theory of imitation based on results argues that organizations imitate those practices which seem to have produced better results in the past, while avoiding those which have led to bad results (Haunschild and Miner 1997). In this case, selective imitation comes from the perceived consequences of a given practice.

*Our analysis shows that a downturn in sales often precedes downsizing practices...*

Its presence has been identified in the processes of diffusion of an innovation, since this adoption will increase if the organizations attribute profitability to an innovation after observing the results obtained by companies who have already adopted it (Haunschild and Miner 1997). As a result, organizations are less likely to imitate innovative practices that are only in their early stages. They prefer to keep observing the new practices until they are proven to be successful.

In the case of the diffusion of corporate downsizing, organizations will be more likely to imitate this practice when they perceive a good result after the first cases observed, since this allows them to attribute a positive effect to downsizing.

**H3:** the adoption of downsizing practices by a company is positively related to positive results that other companies obtained after downsizing.

**Empirical Analysis**

This section contrasts a causal model in the adoption of downsizing practices carried out by Spanish companies from 1994 to 2000. The model takes into account institutional factors, which represent different types of imitation among organizations. It also considers other determinants, which reflect via control variables the influence of corporate characteristics such as size or age, or of economic factors, on the decision to downsize.
Population and Sample

This study has made use of the Spanish database “Encuesta sobre Estrategias Empresariales” (Survey on Business Strategies, hereafter ESEE), which the SEPI Foundation runs via its Programme of Economic Research (Programa de Investigaciones Económicas).

The ESEE is an annual statistical survey of a panel of companies which represent the manufacturing industries, and whose reference population consists of companies with 10 or more employees in what is usually known as the manufacturing industry. The geographical scope covers the whole of the national territory and the variables have an annual temporary dimension.

One of the most important features of the ESEE is its level of representation. The initial selection of companies was carried out combining criteria of exhaustiveness and random sampling.

The period under study is 1994 to 2000, during which the Spanish labor market underwent considerable flexibility. This fact, together with the consequences of the 1993 crisis, encouraged the diffusion of downsizing in Spanish companies.

The process used to determine the sample used in the empirical analysis consisted of selecting those registers which offered information in each of the years under study (from 1994 to 2000), and which did not undergo any changes. After this selection process the sample consisted of 940 Spanish manufacturing companies (6580 items).

Measurement

Dependent Variable: Downsizing. This is a dummy variable that codes as one when a company downsizes and as zero otherwise. To construct this variable we calculated the ratio \( \text{Change}_t = \frac{(\text{No. of Employees}_t - \text{No. of Employees}_{t-1})}{\text{No. of Employees}_{t-1}} \), where No. of Employees, is the number of permanent employees (i.e., excluding temporary personnel) in year t, and No. of Employees_{t-1} is the number of permanent employees in year t-1.

As previous studies showed (Cascio et al., 1997; Ahmadjian and Robinson, 2001), we consider that downsizing occurs when the number of permanent employees is reduced by 5% or more from year t-1 to year t.

We applied three cut-off points to analyze the downsizing activities in the Spanish manufacturing sector during 1995-2000: 2%, 5% and 10%. All three curves displayed a similar pattern. As did Ahmadjian and Robinson (2001), we used sensitivity tests to examine whether our results varied if we changed the cut-off point from 0.05 to 0.10 and 0.02 and the results were broadly consistent.

Independent Variables

Number of previous downsizing events in the sector (DOWNSEC). This variable is constructed by totalling the number of downsizing events that have been carried out by companies in the same sector in the years previous to year t. For this purpose, we have identified the cases in which the downsizing variable appears with value 1 in companies that have the same code in the activity field. The companies’ main activity is classified by the ESEE using the NACE-CLIO R44 codes of modified sectorial classification (and the equivalent CNAE-74), which correspond to the eighteen sectors.

Number of previous downsizing events implemented by leaders in the sector (DOWNLEAD). This variable supplies information on the number of times the five leading companies in the sector in question have implemented downsizing in the years prior to year t. In order to obtain this data, first the five companies with the highest turnover (sales volume) were selected in each sector. The cases of downsizing carried out by
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these companies were then calculated, again grouped by sector. This therefore shows in numerical values the quantity of downsizing events implemented by the leaders in each sector for each year.

**Economic success attributed to previous downsizing events (SUCCESSDOWN).** This variable has measured by sector the variation in performance in year t-1 of those companies that have practised downsizing in year t-2. When this variation is positive (negative), this success (failure) in year t-1 is attributed to the implementation of downsizing.

**Control Variables**

**Number of previous downsizing events in the company (DOWNCOMP).** In each of the years considered (1994-2000) the number of occasions on which downsizing has been implemented previously in the company has been calculated.

**Time lapse between consecutive downsizings (TIMELAPSE).** The period between consecutive downsizing events in a given company is calculated as the difference in years between said events.

**Variation in Performance (VARPERF).** As the ESEE does not include questions in its survey about company profits but does include the necessary data to calculate them, the value of gross profit has been calculated. This variable reflects the percentage variation between performance in the previous year (t-1) and the year in course (year t).

**Variation in Sales (VARSales).** The percentage variation in sales between two consecutive years is calculated for each company.

**Variation in Productivity (VARPROD1 and VARPROD2).** Two variables have been used to measure the variation in labor productivity of each company in years t and t-1: (1) VARPROD1 is the ratio of personnel costs against sales figures; (2) VARPROD2 calculates the ratio of sales against personnel.

**SIZE.** Company size has been measured using the total number of employees, i.e. total permanent personnel. The natural logarithm of the total personnel has been calculated to obtain an indicator of company size.

**AGE.** This variable is measured taking the difference between the year in question and the year in which the company was set up.

**Degree of Diversification (DIVERS).** To measure this variable, the Index of Total Entropy has been adapted, considering the proportion of sales of each company in the 5 main markets in which it intervenes. This indicator must be understood as an approximation to customer diversification, as it has not been possible to calculate the diversification in activities. The ESEE database only provides the code of the main business activity of each company, and so we have not been able to use the diversification indicators traditionally employed in the literature. The entropy measure, denoted as *Diversification*, was used to indicate the firm’s degree of diversification:

\[ Diversification = \sum_{k=1}^{5} p_k \ln(1/p_k) \]

where \( p_k \) was the percentage of sales of the focal firm in the \( k \)th \((k = 1, 2, ...,5)\) main markets in which the firm operated. The ESEE survey identifies a firm’s five main markets, defined by product line, client/customer, and geographical market.

**Degree of debt (DEBT).** This variable has been calculated from the coefficient of debt, using data from year t-1.

**Owners in management posts (FAMILY).** This variable indicates whether relatives of the owners occupy relevant executive or administrative posts in the company. It is used as a control variable, as the type of owner is expected to influence the decision to adopt
downsizing (Suárez and Vicente 2000; Budros 1997). This variable takes value 1 when said family members are present, and 0 if not.

Gross Domestic Product (GDP) annual growth rate ($v_{GDP}$). We used the annual Spanish GDP growth rate in each year, as expressed in 1990 Spanish currency.

**Methodology and Results**

This study is of a dynamic nature, and so the use of panel data is particularly suitable. This panel contains entries of certain variables for all the companies in the sample (940) in each of the years under study (1994-2000).

The analysis of logistic regression with panel data (logit model) is a suitable model for the study of the likelihood of downsizing in a given company. Using the likelihood or frequency of downsizing as a dependent variable makes it advisable to opt for logistic analysis (Suárez and Vicente 2000).

**Results**

Table 1 displays descriptive statistics and correlations for the variables used in the analysis. The collinearity diagnostics (variance inflation factors) indicate that multicollinearity was not a problem in the statistical analysis.

Once the data have been analyzed by means of logistic regression with the two alternative models (fixed effects and random effects), the random effects model has been chosen, since it allows the number of observations used in the estimation to be increased considerably (from 3,686 to 5,472). This reasoning has been used in

<table>
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<th>s.d.</th>
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<td>0.09</td>
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other works following a similar methodology (e.g. Suárez and Vicente 2000).

companies look out for their own interests

Table 2 shows the results obtained after carrying out this logistic regression analysis for the period under study. First of all, it can be observed that the fit is significant, since the chi squared statistic has a high value, and it is significant for a confidence level of 99%. Another interesting fact to bear in mind is the use of 83.2% of the observations from the sample (data from only five companies are lost).

We shall now analyze which variables have proven to be significant to explain the downsizing phenomenon, and the sign of their relationship with the dependent variable. This will allow us to ascertain which of the hypotheses proposed in the causal model have obtained sufficient evidence.

The analysis carried out indicates that the Downsec variable is not significant, and so it proves impossible to verify hypothesis H1. Nevertheless, this is not the case for the Downlead variable, which is significant, and which has a positive influence on downsizing, thus supporting hypothesis H2. As for hypothesis H3, it has proved impossible to verify due to the lack of significance obtained by the Successdown variable.

As regards the control variables, Downcomp is significant with a negative sign, whereas Timelapse is also significant but with a positive sign. The economic effect of performance previous to downsizing is not proven, as is indicated by the lack of significance of the Varperf variable.

On the other hand, Varsales turns out to be significant at 1%, influencing the dependent variable with a negative sign. Evidence is also obtained showing that labor productivity influences the dependent variable, since the Varprod1 variable is significant with a positive sign, and Varprod2 is also significant, but with a negative sign. The variables Debt and GDP are both positively significant.

The results of this analysis also provide evidence to the effect that Size has a significant negative influence on the dependent variable. The Age variable is shown to be significant as an explanatory variable of the downsizing phenomenon, and its sign is positive. However, this analysis has made it clear that the independent variable Divers is not significant in the established relationship, and neither is the control variable Family.

Finally, the logistic analysis reveals the importance of individual effects through
the value of rho (i.e. the proportion of total variance due to individual effects). The contrast that is shown at the end of Table 2 leads to the conclusion that unobservable heterogeneity exists with a confidence level of 99%.

Discussion
The first step of this empirical study has been to analyze the factors that explain the downsizing phenomenon according to the theoretical framework adopted previously. Its basic characteristic is that it allows the co-existence of two types of causal factors: exogenous factors or those of an institutional nature, and endogenous or inter-organizational ones (Greenwood and Hinings 1996).

The three causal relationships that the causal model established aimed to prove the existence of mimetic isomorphism in organizations in order to explain the adoption of downsizing practices. These relationships were proposed thanks to the identification of the three different types of interorganizational imitation: those depending on frequency, characteristics or results (Haunschild and Miner 1997).

With the data of the Spanish companies in the sample, no evidence has been found for the existence of a relationship between the implementation of downsizing by a company and the number of cases of downsizing that has occurred previously in other companies in the same sector. Thus, unlike other studies (Vicente and Suárez, 2007; Haunschild and Miner 1997; Fligstein 1985), the present one has not been able to prove that downsizing has occurred due to imitation of the behavior of a considerable number of organizations in the same sector, also termed imitation based on frequency.

The second type of imitation analyzed is based on the characteristics of the organizations, and it explains the adoption of downsizing due to companies emulating the behavior of the most important firms in their sector, i.e. the leaders. By selecting the five leading companies in each sector, strong evidence is obtained to the effect that the prior adoption of downsizing practices by these leaders has a positive influence on the likelihood of another company imitating such behavior. This empirical evidence supports that of Haunschild and Miner (1997) to demonstrate the imitation of organizations with certain common characteristics (in their case, size and success). This supports the theory, which argues that organizations carry out certain practices in order to achieve the legitimacy that the most successful organizations (leaders) in their respective sectors enjoy (Scott 1995; Hoffman 1997).

...the implementation of downsizing by the most successful companies influences the adoption of this practice by other organizations.

Finally, the third type of interorganizational imitation predicted as an antecedent of the implementation of downsizing by an organization is based on performance. Thus it was expected that companies would be more likely to carry out downsizing when they observed that those companies that had already done so had obtained an improvement in performance. In this case the reason behind the imitation of downsizing is that it perceived to be the only cause of the improvement in the organization’s results. However, the statistical analysis has not provided the necessary support to verify such a relationship in the period under study.

In short, it may be stated that the social legitimization obtained by downsizing led Spanish manufacturing companies to imitate this practice between 1994 and 2000 via one of the institutional mechanisms: mimetic isomorphism. On analyzing this imitation process in more detail it has been shown that it is due to the imitation of previously observed behaviors on the part of leading companies in the different sectors. Consequently, of the
three kinds of imitation identified, the only one that is verified is that based on characteristics. This result contrasts with that of Haunschild and Miner (1997), since their empirical study corroborated the three types in the case of choosing an investment bank as a consulting agent by those companies that were about to take over others.

The results obtained in the analysis provide sufficient support to verify the explanatory power of another type of factor in the adoption of downsizing in Spanish industrial firms during the period 1994 to 2000. Although it has not been observed that a firm's suffering a loss, or problems in corporate performance, have led to personnel reductions, it has been possible to relate this practice with a previous downturn in corporate productivity or profitability. In other words, it seems clear that this type of practice is both reactive or defensive in the face of a negative corporate scenario, and proactive or anticipated (Cameron 1994; Freeman and Cameron 1993; Lamertz and Baum 1996).

Our analysis shows that a downturn in sales often precedes downsizing practices. This agrees with other empirical studies (DeWitt 1998; Suárez and Vicente 2000; Ahmadjian and Robinson 2001). As in the analysis of Spanish companies carried out by Suárez (1999), in the present analysis it has also been possible to associate the existence of problems of labor productivity with subsequent layoffs. These results are in contrast with other previous empirical works that have been unable to prove such a relationship between labor productivity and downsizing (Ahmadjian and Robinson 2001; Suárez and Vicente 2000).

The present study does not allow us to confirm a positive relationship between size and downsizing, unlike a previous work on Spanish companies (Suárez 1999), which found that larger companies experience a “necessity for change” due to redundancies and inefficiencies (Suárez and Vicente 2000; Budros 1997). Rather, based on our evidence it would be more appropriate to state that it is the smaller firms that are more likely to carry out downsizing. As regards age, the results of the present analysis indicate that the older companies were more likely to downsize in Spain from 1994 to 2000, which contrasts with the findings of Suárez and Vicente (2000).

To date no evidence has been found in the literature between diversification and downsizing, and the present study is no exception. The degree of diversification has not obtained sufficient significance to explain said phenomenon. A possible explanation of these results may be that as in this empirical analysis smaller companies have appeared more likely to carry out downsizing, it stands to reason that such companies are less likely to diversify their activities.

On the other hand, it has been possible to relate a greater likelihood of layoffs with a greater use of outside capital. This result contrasts with the findings of the empirical work of Requejo (1996), which did not consider that the level of debt influenced decisions of downsizing, as it did not obtain sufficient significance.

Finally, whether or not the company is managed by the owners does not appear to affect the decision to implement downsizing measures.

Conclusions

Following the tendency of part of downsizing literature (Budros 1999; Love 2000; Sánchez and Suárez 2002) of proposing integrating models with different theoretical approaches to explain the downsizing phenomenon, this work has developed a causal model from the institutional perspective. This does not mean that those companies that implement downsizing do so only due to exogenous factors (Oliver 1991), that is, factors which represent pressure from the environment.
to adopt said measures. On the contrary, a modern institutional theory can explain the diversity of responses in the face of institutional pressures by attributing the organization with an active role in the quest to satisfy its own interests (Greenwood and Hinings 1996; Dacin et al. 2002). Consequently, this institutional focus establishes complementarity between explanatory factors that are characteristic of the economic or rational perspective and strictly institutional factors.

The institutional determinants analyzed refer – basically – to the mimetic isomorphism of the cognitive pillar of the institutions (Scott 1995), which is present at an interorganizational level. The results of this empirical analysis only support interorganizational imitation based on characteristics. This indicates diffusion of the practice of downsizing among the Spanish business population, and that this diffusion is fundamentally due to imitation of the leading companies in each sector which have previously carried out downsizing.

One of the contributions of the present work lays in the fact that it is able to show, at least partially, an institutional origin for a corporate management practice. This contribution supports the evidence that Suárez and Vicente (2000) obtained for Spanish companies. Moreover, it seems the implementation of downsizing by the most successful companies influences the adoption of this practice by other organizations. This may provide evidence for studies on business management trends (e.g. Abrahamson and Fairchild 1999). These studies use the ‘influencing’ argument as one of the possible discourses aimed at spreading the trend itself. In this case there is a clear presence of the “jumping on the bandwagon” discourse in the dissemination phase of a popular management practice (Hirsch 1972; Abrahamson 1996). Thus, the explanation of the behavior of those organizations that downsize lies in their imitation of the behavior of the leading companies in their sector.

One possible explanation of the fact that no evidence has been obtained to support the other institutional factors analyzed may be found in the characteristics of the Spanish labor market. In the European context, and more specifically in the case of Spain, the diffusion of downsizing may be said to be the result of a deinstitutionalization process of the system of permanent employment. In this sense, as has been argued for the case of Japan (Ahmadjian and Robinson 2001), the organizations which practice downsizing first risk losing their legitimacy, but as the institutional context co-evolves (Hoffman 1997) these practices become accepted by the environment and no hostile reaction is produced. A longer time interval would therefore be necessary in order to observe a greater presence of institutional determinants among Spanish companies.

On the other hand, the causal relationships detected between economic factors and downsizing indicate that companies look out for their own interests, despite being subjected to institutional pressures which seek to influence their behaviour (Greenwood and Hinings 1996; Dacin et al. 2002).

Finally, as another conclusion of the present work, we have determined the characteristic profile of the Spanish industrial companies that carried out downsizing in the period under study. In the main these were small companies, established for some time and with little diversification. The fact that these results contrast with those obtained in other studies on downsizing in Spanish companies (Suárez and Vicente 2000) may be due to the use of different databases. This fact highlights the need to carry out further studies of this type in different business populations with a view to determining the profile that best fits their behavior. In this sense, our second contribution consists of offering empirical evidence for a location different from the U.S. As Scott pointed out (2005, 478): "An embarrassingly large proportion of our theoretical conceptions
and empirical findings have been constructed by U.S. scholars based on data collected from U.S. organizations."

Our results also provide some useful implications for practice. First, the diffusion of some management practices, such as downsizing, follows the pattern of a firm fashion (Abrahamson, 1996). These fashions spread among the company population without the existence of clear evidence about their positive influence on the results. Our study shows that the imitation effect is important to explain firms' adoption of downsizing. One explanation is that firms should cautiously assess whether or not to implement these practices. Managers have to be aware of the reasons that lead them to downsize. To obtain legitimacy in their industry may not be reason enough if the company has not done another kind of analysis.

Moreover, many studies have found evidence of the negative effects of downsizing on different aspects of firms, which finally drives them to reduction in performance (Cascio et al., 1997; Guthrie and Datta, 2008). Furthermore, evaluation of the available evidence can allow managers to understand the way in which downsizing must be implemented in order to produce less prejudicial effects. For example, Cameron (1994) and Cascio et al. (1997), among other authors, found that only a downsizing strategy that involves a wider restructuring and systematic strategy (not a reactive strategy) could provide results that are less prejudicial to the company.

Limitations

The present research work presents a series of limitations that may serve as a basis for future research.

Firstly, the central topic of this study is downsizing, and there are many processes and techniques by which this concept may be implemented (Freeman and Cameron 1993; Cameron 1994). However, the statistical information available in the ESEE database used does not allow us to differentiate between downsizing modes (layoffs, early retirement, outplacement, attrition or freezing new contracts, etc.). This limitation has meant that the empirical analysis was limited to reductions in the number of full-time employees, a choice which was supported by its representivity of total personnel, without being able to distinguish the particular downsizing strategy used. Therefore, although the data allow certain conclusions to be reached on the magnitude of downsizing in Spain, it may be supposed that it would be even greater if the study took into account the other measures used in Spanish companies to reduce the workforce.

In the empirical analysis carried out, the choice of database is another limitation, since Spanish industrial companies have been chosen. This choice may mean that the conclusions reached from the results obtained are not valid for any other context. For this to be possible, the context would have to have several similarities from the institutional point of view related to downsizing i.e. a different geographical area in which the regulations and the normative/cognitive aspects have fomented the legitimization of downsizing in society. This would be the case of most western countries and contrasts with others, such as Japan (Ahmadjian and Robinson 2001).

Since the database is limited to Spanish industrial companies, this creates another limitation, which is the impossibility to generate conclusions that can then be extrapolated to other areas of activity, such as services. In these areas the literature predicts less impact of downsizing due to the employee-oriented culture (Budros 1997).
There is no doubt that the time interval studied in the empirical analysis constitutes another limitation of this work. Information is available from the ESEE surveys from 1990, but the period of study had to be restricted to 1994-2000, since in the previous years the sample of companies was not sufficient to validate the analysis. This makes it impossible to study the whole decade. Furthermore, information is lost for 1992 and 1993, which were particularly important years for downsizing as a result of the incidence of the world economic crisis. Although it would have been desirable to extend the period under study, this has not prevented significant evidence from being obtained to support the causal model proposed.

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Why Are Spanish Companies Implementing Downsizing?


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Separate Financial Reporting Standards and Standard Setting for Private Companies

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Executive Summary

In 2011, the Blue-Ribbon Panel on Standard Setting for Private Companies (the Panel) issued its report to address how accounting standards can best meet the needs of users of U.S. private company financial statements, and concluded there are urgent and growing systemic issues that need to be addressed in the current U.S. accounting standard setting system.

At present, there are approximately 28.5 million private companies in the United States and approximately 14,000 public companies. Public companies have financial reporting requirements to the Securities and Exchange Commission (SEC) pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. The “investor protection” mandate of those Acts has made the SEC a major force in the U.S. standard setting process both as a consequence of SEC regulations, interpretations, policy statements, Staff Accounting Bulletins, and other issuances as well as the SEC role as observer to the meetings of the Financial Accounting Standards Board (FASB) and the Emerging Issues Task Force (EITF). Over time, the investor focus of United States generally accepted accounting principles (U.S. GAAP) has not only dwarfed the concerns of other users but has also diminished the relevance and usefulness of financial statement information to other users.

Many of the private companies in the U.S. are very small businesses and thus have no reporting requirements other than filing income tax returns. There are, however, a significant number of private companies that prepare financial statements in accordance with U.S. GAAP because such financial statements are required by lenders, other creditors, bonding and credit-rating agencies, regulators, business owners, and others. Many private companies preparing U.S. GAAP financial statements must issue audited, reviewed, or compiled financial statements. The primary concern of the Panel is that there are an increasing number of private company financial statements that are prepared in accordance with an Other Comprehensive Basis of Accounting (OCBOA), or the financial statements contain departures or exceptions to U.S. GAAP, which are disclosed in the accountant’s or auditor’s report. This article discusses the current developments in establishing separate accounting standards for private companies and how different
objectives of financial statement users should be addressed.

Introduction

In 2011, the Blue-Ribbon Panel on Standard Setting for Private Companies (the Panel)\(^1\) issued its report to address how accounting standards can best meet the needs of users of U.S. private company financial statements, and concluded there are urgent and growing systemic issues that need to be addressed in the current U.S. accounting standard setting system.

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There are urgent and growing systemic issues that need to be addressed in the current U.S. accounting standard setting system.

Many users of private company financial statements are willing to accept audited, reviewed, or compiled financial statements with departures from U.S. GAAP because the principles involve a number of accounting standards that lack relevance to these users in their decision making process. The Panel notes that the accounting standards often thought of as not relevant include guidance on: variable interest entities, uncertain tax positions, fair value measurements, and goodwill impairment.

The Panel’s Conclusions

The Panel notes that there is an increase in costs to provide potentially irrelevant information, and that has led to more users who are willing to accept qualified opinions.

This development, the Panel concludes, calls into question whether those aspects of U.S. GAAP are truly “generally accepted.”

Specifically, the Panel concludes in its report that in the current system of accounting standard setting, the FASB has not done a sufficient job of:
• Understanding the information that users of U.S. private company financial statements consider decision-useful and how those information needs differ from the information needs of users of public company financial statements; and

• Weighing the costs and benefits of GAAP for use in U.S. private company financial reporting, and recognizing that most private companies preparing GAAP financial statements do not have the accounting resources that are available to public companies.

The Panel states that the above issues have caused a lack of relevance of a number of accounting standards for many users of private company financial statements, and has resulted in an overall level of complexity in U.S. GAAP that continues to concern preparers of private company financial statements and their accountants. The Panel states that U.S. private companies incur significant and unnecessary costs for GAAP financial statement preparation and audit, review, or compilation services. To address those issues the report proposes that:

• Major and other enhancements, at least in the near term, should be made that are aimed at fostering an accounting standard-setting system that would seek to maintain a high degree of financial reporting comparability for business entities, regardless of capital structure, but also significantly increase the chances of effecting potential differences, where warranted, in measurement, recognition, and presentation, and not just disclosure.

• The system should focus on making exceptions and modifications to U.S. GAAP for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP.

U.S. private companies incur significant and unnecessary costs for GAAP financial statement preparation and audit, review, or compilation services.

Models and Structures Examined by the Panel

The Panel developed its recommendations after examining a full range of options that included everything from maintaining the status quo to developing an entire new set of standards for private companies. In making the recommendation for a new accounting standard setting board, the Panel considered the actions currently under way by the FASB to help improve the standard-setting process for private companies, along with the recommended short-term and transitional actions. However, the Panel notes those actions do not remove the need or the urgency for a new standard-setting board for private companies.

The Panel considered various models and structures as alternatives to the current standard-setting process to develop its best recommendations for addressing the systemic issues and best facilitate financial reporting that meets the needs of users of private company financial statements in a manner that is cost-effective for private company preparers, practitioners, users, and others in the financial system. The Panel initially debated the following models:

• U.S. GAAP with exceptions and modifications for private companies—current system. (The status quo is unacceptable.)

• U.S. GAAP with Exceptions and Modifications for private companies—with process enhancements

• Baseline U.S. GAAP with add-ons for public companies
• Separate, standalone U.S. GAAP for private companies derived from current U.S. GAAP
• Separate, standalone U.S. GAAP for private companies developed from the ground up based on robust private company framework
• International Financial Reporting Standards (IFRS) for small and medium sized entities (SMEs) as issued by the International Accounting Standards Board (IASB)
• IFRS for SMEs customized (“Americanized”) for U.S. private companies

The models included several based on U.S. GAAP and two based on IFRS. In all the U.S. GAAP-based models except the current system model, the creation of some sort of underlying, standard-setting framework for private companies was viewed as a near-term necessity. The private company framework in the respective models ranged from a differential framework to a separate, ground-up framework. The Panel concluded that the IFRS-based models already had an underlying set of decision criteria created by the IASB.

The Panel rejected four of the models during its initial deliberations for the following reasons:

• U.S. GAAP with Exceptions and Modifications for Private Companies—current system The status quo is unacceptable.
• Separate, standalone GAAP for private companies developed from the ground up based on robust private company framework. This could take a significant amount of time to create and could be significantly different from current U.S. GAAP
• IFRS for SMEs as issued by the IASB. U.S. private companies should not adopt an IFRS-based set of standards before the SEC makes a decision on U.S. public companies.
• IFRS for SMEs customized for U.S. private companies. Same concerns as above.

The Panel did consider a baseline U.S. GAAP model with add-ons for public companies and the separate, standalone GAAP model for private companies derived from current U.S. GAAP, but those models were not supported as near-term solutions. The Panel notes that a baseline approach or a separate private company GAAP approach based on current U.S. GAAP would be in the best, long-term interest of users of U.S. private companies' financial statements within the broader context of the overall U.S. financial reporting system.

Under a baseline GAAP model, the “burden of proof” would shift more to justifying why users of public company financial statements need certain information, rather than why users of private company financial statements do not. The separate private company GAAP approach would permit a more exclusive focus on the needs of users of private company financial statements, more than would other models.

There was an overriding concern among the Panel that a baseline GAAP model or a separate private company GAAP model would likely take much longer and be more costly to implement than a GAAP model with exceptions and modifications, with enhancements to the current system. As such, the Panel rejected those models because of expediency and supported a GAAP model with exceptions and modifications, with enhancements to the current system, for reasons of consistency and comparability.

**Major Enhancements Supported By the Panel**

The Panel’s recommendation includes a new separate standard-setting board operating under the authority of the Financial Accounting Foundation (FAF) that would be given the
authority to determine which exceptions or modifications for private companies would be made to the U.S. GAAP. The separate private company standards board would work closely with the Financial Accounting Standards Board in the standard setting process, with the goal of ensuring that the needs of users of private company financial statements are met, and ensuring that appropriate and sufficient exceptions and modifications are made, for both new and existing standards.

The Panel recommends the separate standard-setting board as necessary because “the current FASB and even a restructured FASB cannot produce the needed exceptions and modifications to GAAP for private company financial reporting.” The Panel also recommends that the new board have sole authority to determine what exceptions or modifications would be made to FASB standards in their application to private companies. The Panel’s recommendations also include the following. That:

- The standard-setting process for the new board be similar to the FASB’s current process, and that the new board could decide to issue a separate exposure draft of a proposed FASB accounting standard when proposing an exception or modification for private companies, or it could issue a joint exposure draft with the FASB. The Panel notes that the new board would not be allowed to issue a separate, unique set of accounting standards for private companies, but could only issue the FASB’s accounting standards showing modifications or exceptions for private companies.
- The new board would be composed of five to seven members with a full-time chair, and that board members would need to have the perspective of private-company stakeholders and have experience as users, preparers, or auditors of private-company financial statements.
- The Financial Accounting Foundation would conduct a comprehensive review of the effectiveness of the new board after three to five years to evaluate its effectiveness and to determine whether to maintain it as is, make additional process improvements, or sunset it.
- A differential framework (set of decision criteria) would be created to facilitate a standard setter’s ability to make appropriate, justifiable exceptions and modifications.
- The FAF and the FASB would undertake short-term or transitional actions to provide near-term relief for private companies and help ensure a smooth transition to a new board by: (a) continuing to work with the Private Company Financial Reporting Committee to receive appropriate input on private-company financial-reporting issues and related cost-benefit considerations as the FASB develops proposed accounting standards; (b) continuing to hold private-company roundtables to obtain additional input to its standard-setting process; and (c) considering whether changes can be made to the comment process to encourage participation from private-company stakeholders.

Survey Conducted by the New York Society of Certified Public Accountants (NYSSCPA)

The NYSSCPA conducted a survey² of its membership and a straw poll at its leadership conference to answer the following three primary questions addressed by the Panel:

- Should there be a separate set of accounting standards for private companies?
- If yes, should they be a new set or exceptions and modifications to existing GAAP?
• If yes, what authoritative body should be charged with writing the standards?

The results of the web-based survey, which included more industry members than were at the conference, was as follows:

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Should there be a separate set of accounting standards for private companies?</td>
<td>85%</td>
<td>15%</td>
</tr>
<tr>
<td>If yes, should they be a new set, or exceptions and modifications to existing GAAP?</td>
<td>38%</td>
<td>62%</td>
</tr>
<tr>
<td>If yes, what authoritative body should be charged with writing the standards?</td>
<td>53%</td>
<td>47%</td>
</tr>
</tbody>
</table>

**Table 1**

A new separate standard-setting board operating under the authority of the Financial Accounting Foundation (FAF) [should] be given the authority to determine which exceptions or modifications for private companies would be made to the U.S. GAAP.

In the straw poll that was conducted at the NYSSCPA annual leadership conference, among a group composed predominantly of certified public accountants, the results of the first two questions remained the same; however, they preferred to have the FAF create a separate body to write the standards, not the FASB. Many believe that the FASB has showed through its past actions that it has a vested interest in supporting its standard for publicly-held entities, and a more independent approach would be better. Specifically, the leadership straw poll results were as follows:

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Should there be a separate set of accounting standards for private companies?</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>If yes, should they be a new set or exceptions and modifications to existing GAAP?</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>If yes, what authoritative body should be charged with writing the standards?</td>
<td>45%</td>
<td>55%</td>
</tr>
</tbody>
</table>

**Table 2**
Separate Financial Reporting Standards and Standard Setting for Private Companies

FAF Board of Trustees Establish Private Company Standards Improvement Council

In October 2011, the FAF’s Board of Trustees (Trustees) established the Private Company Standards Improvement Council (PCSIC) instead of an independent standard setting board for private companies. The Trustees’ refusal to adopt the Panel’s recommendation on improving the standard-setting process for private companies disagreed with the more than 3,000 letters from private company constituents and the 30-plus state CPA societies who wrote supporting the Panel’s recommendation.

The Trustees emphasize their belief that creating a separate standard-setting board for private companies would likely lead to the establishment of two separate sets of U.S. accounting standards: a so-called “little GAAP” for private companies and a “big GAAP” for public companies. They note that the PCSIC, jointly with the FASB, would determine whether exceptions or modifications to non-governmental U.S. GAAP are required to address the needs of users of private company financial statements.

The Trustees conclude that the PCSIC and the FASB would jointly develop criteria for determining whether and when exceptions or modifications to U.S. GAAP are warranted for private companies. The Trustees also state that based on those criteria, the PCSIC would conduct a review of existing U.S. GAAP and identify standards that require reconsideration and vote on possible exceptions or modifications for private companies. The Trustees note that any proposed changes to existing U.S. GAAP would be subject to ratification by the FASB and undergo due process, including public comment. The PCSIC would be overseen by the FAF Board of Trustees.

The Trustees define the structure of the PCSIC to comprise 11 to 15 members and a chairman. The Trustees would select and appoint the chairman, who would be an FASB member with experience and exposure to private companies during his or her career, as well as the PCSIC members who would serve for a three-year term.

The Trustees noted that during the first three years of operations, the PCSIC would provide periodic reports to its newly created Private Company Review Committee, and would provide quarterly written reports to the Trustees. Following the three-year period, the oversight responsibilities of the Private Company Review Committee would be transferred to its existing Standard-Setting Process Oversight Committee. The Trustees note that they will conduct an overall assessment of the PCSIC at the end of the three-year period to determine whether its mission is being met and whether further changes to the standard-setting process for private companies would be warranted.

AICPA Governing Council Demands an Independent Board

On October 2011, the American Institute of Certified Public Accountants’ (AICPA) Governing Council responded to the FAF’s Trustees’ refusal to establish an independent standard setting board for private companies by overwhelmingly approving a resolution to notify the Trustees that they should adopt the Panel’s recommendations for a separate standard setting board, or the AICPA will consider other options.

The AICPA Governing Council noted that if FAF continues to pursue its October 2011 proposal, the Council will look at other solutions for addressing the needs of private companies, including the creation of a separate standard setting body to develop private company generally accepted accounting principles (PCGAAP), or a comprehensive private
company-specific basis of accounting that would deliver meaningful, lasting improvement to private company financial reporting consistent with the Panel's recommendations.

The AICPA president and CEO stated that the FASB has proven over many years that it cannot deliver meaningful improvement to private company reporting standards, and that the FASB's primary focus has been and should be on the public company sector and on international convergence. The AICPA president went on to say that fifty percent of the U.S. economy comprises private companies and this critical sector of the economy deserves a board focused solely on their specific needs.

The AICPA note that given the historic FASB vetoes to accept key modifications to U.S. GAAP, it is expected that identifying and executing needed differences in U.S. GAAP standards for private companies would be unlikely to occur, if at all, until 2014, which would be a full four years since the formation of the Panel and nine years since the AICPA Private Company Financial Reporting Task Force called for fundamental change to the standard-setting process for private companies.

The AICPA also noted that the FAF Trustees' proposal is unresponsive to the Panel's demand for immediate action. In its resolution, which is contained in Appendix A, the AICPA Governing Council reaffirmed its position that an independent standard-setting board should be established for privately-held companies, because it is imperative that they be better served in the near future.

Appendix A

AICPA Governing Council Resolution – Private Company Financial Reporting

WHEREAS, In October 2009 this Council overwhelmingly supported differences in U.S. GAAP, where appropriate for private companies; and

Fifty percent of the U.S. economy comprises private companies and this critical sector of the economy deserves a board focused solely on their specific needs.

WHEREAS, In November 2009 the AICPA Board of Directors approved a motion approving the AICPA continuing its efforts to determine how GAAP for private companies should be set and the resulting form of those standards, including forming and participating in a Blue Ribbon Panel on Standard Setting for Private Companies; and

WHEREAS, In January 2011 the Blue Ribbon Panel on Standard Setting for Private Companies, a broad-based group representing bankers, sureties, venture capitalists, chief executive officers, preparers, CPA practitioners and regulators, recommended the establishment of a private company standards board under the Financial Accounting Foundation, similar to the Financial Accounting Standards Board and the Governmental Accounting Standards Board, to set differences in U.S. GAAP standards, where appropriate, for privately-held companies; and

WHEREAS, In October 2011 the Financial Accounting Foundation proposed a model for the consideration of differential standards that rejected that recommendation, despite receipt of letters from over three-thousand private company constituents and over thirty state CPA societies supporting that recommendation, and issued a proposal that fails to create a private company standards board comprised of private company constituent representatives; and

WHEREAS, The Financial Accounting Foundation's proposal would create a new body that would not be constituted until mid-2012 at the earliest, and with members meeting at most six times per year, and with a process involving subsequent Financial Accounting
Standards Board review and approval (as has effectively occurred with the Private Company Financial Reporting Committee in place to date), Council anticipates that identifying and executing needed differences in U.S. GAAP standards for private companies, given the recentabilities of the Private Company Financial Reporting Committee to overcome the reluctance of the Financial Accounting Standards Board to accept key modifications to U.S. GAAP, would not likely occur, if at all, until 2014, which is a full four years since the formation of the Blue Ribbon Panel, which is nine years since the AICPA Private Company Financial Reporting Task Force called for fundamental change to the standard-setting process for private companies, and which is unresponsive to the Blue Ribbon Panel’s demand for immediate action; and

WHEREAS, The private company sector is a major engine of the U.S. economy accounting for approximately 28 million companies nationwide and deserves a true means of achieving relevant and cost-effective financial reporting standards; and

WHEREAS, A standard-setting model, as the one proposed by the Financial Accounting Foundation, that gives authority to the Financial Accounting Standards Board (whose focus is on and should be on the public company sector and on international convergence) over the setting of differential standards for private companies, has been proven incapable of delivering meaningful improvement to private company financial reporting over many years and resulted in diversity in practice for private company financial reporting;

WHEREAS, Council has supported and continues to support the establishment of a private company standard-setting board under the Financial Accounting Foundation, inasmuch as a board comprised of individuals working in, serving, or using the financial statements of private companies can best set the differences to U.S. GAAP for private companies; and

WHEREAS, The Financial Accounting Foundation’s proposal does not encompass such a standard-setting board, but instead would create a new body which in essence is a continuation of the current Private Company Financial Reporting Committee with no power to set standards and only inconsequential modifications and a new name, and which is therefore not adequate to deliver meaningful change to private company financial reporting in a timely manner; and

WHEREAS, Council is desirous of AICPA taking further action to support and achieve the recommendations of the Blue Ribbon Panel and provide relevant financial reporting standards to the private company sector without delay;

NOW THEREFORE Council approves the following resolution:

BE IT RESOLVED, That this Council instructs AICPA’s Board of Directors to submit to the Financial Accounting Foundation a comment letter setting forth AICPA’s disagreement with the Financial Accounting Foundation’s proposal and restating AICPA’s support for the recommendations made by the Blue Ribbon Panel; and

BE IT FURTHER RESOLVED, That because the Financial Accounting Foundation’s proposal does not contain the establishment of a board under the Financial Accounting Foundation empowered to set differences in U.S. GAAP standards where appropriate for privately-held companies, which is the preference of this Council, and if the Financial Accounting Foundation’s proposal is not modified to include such a board under the Financial Accounting Foundation, this Council directs the AICPA Board of Directors to consider all options, including consideration of other established independent standard-setting bodies as the standard setter for U.S. GAAP for
private companies, the creation of a committee or board within the AICPA or a standard-setting body as a separate entity, to develop private company generally accepted accounting principles (PCGAAP) or a comprehensive private company-specific basis of accounting that would deliver meaningful, lasting improvement to private company financial reporting consistent with the Blue Ribbon Panel recommendations.

Endnotes

1 The American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) jointly established the Blue Ribbon Panel in December 2009. The Panel is comprised of individuals representing users and preparers of private-company financial statements, CPA firms, academia, and an industry group.

Do Investors Care About Earnings Management?

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Executive Summary

If earnings management is nothing but deceit, the market should not react differently to an adverse event for firms that manage earnings versus those that do not. Furthermore, if the market is efficient and earnings management is a manifestation of agency problems, investors should penalize the firms that manage earnings more. However, based on a sample of 98 drug terminations by biotechnology firms in the United States, our study provides opposite results; that is, *ex ante* earnings management results in less negative market reaction to such adverse events. This not only implies that the market cares about earnings management, it is also against the agency problem-related opportunistic explanation of earnings management.

Introduction

A firm’s reported income or earnings will differ from the true underlying economic income for more than one reason. Part of that difference is attributable to standard accounting practices such as depreciation and amortization. However, top managers also have some discretion in applying the Generally Accepted Accounting Principles. The willful use of that discretion is termed *earnings management*.

Most of the existing academic literature looks at earnings management negatively, as an opportunistically motivated phenomenon. If earnings management is indeed motivated by management’s selfish goals and is, therefore, a manifestation of the agency problem between the firm and its investors, investors should put a lower value on the equity of firms that manage earnings. It is difficult to estimate the hypothetical true earnings stream of a firm that would occur in the absence of earnings management. Similarly, if a firm always engages in this behavior, it is difficult to compare the effect of earnings management on the value of the firm before and after such manipulation occurred. A long run comparison is also fraught with other confounding effects.

For this paper, we study this question in a setting that allows us to infer investors’ perception of earnings management in a more pristine way. We compare the market reaction to an adverse event in the biotechnology industry – the termination of a product in human trials – between firms that manage earnings more than their industry peers and those who do not. If the investors do not care about the earnings management practice, we should not see any difference in the market reaction to this adverse event between the two groups. If, on the other hand, earnings management is a consequence of the agency problem, we would see a bigger negative market reaction for the firms that indulge in this practice.

However, we find the opposite. Market does seem to care for earnings management, but not in a negative way. We find that firms who managed earnings before the adverse event had less negative reaction to the adverse event.
than those who did not. One explanation for this is that the market is efficient and investors recognize that earnings management can be done for efficiency motives. Here efficiency motives are defined as those that seek to maximize shareholders’ wealth. Alternatively, it could imply that the market is inefficient and investors can be easily deceived about the true underlying earnings and value of a firm through earnings manipulation.

Our study contributes to the literature in both finance and strategic management. The finding adds to the scant literature on efficiency-motivated earnings management, and reveals the positive impact of earning management in the face of adverse events. Our paper is also the first paper that looks at earnings management and its consequence in the biotechnology industry.

The remainder of this paper is organized as follows. First, we review prior studies related to adverse events and earnings management and develop the hypotheses pertaining to the relationship between \textit{ex ante earnings} management and market reactions to adverse events. The methodology and analysis are described in the third section. Finally, we conclude with the results and discussion.

\textbf{Literature and Hypotheses}

As mentioned before, extant literature on earnings management deals with opportunistic motives for earnings management only. These opportunistic motives include maximizing management compensation and control (Bergstresser and Philippon, 2006; Cornett, Marcus, and Tehranian, 2008), avoiding management dismissal (DeAngelo, 1988), avoiding regulatory control (Jones, 1991), or minimizing the tax burden (Frank, Lynch, and Rego 2009). For an excellent review of earlier papers on this topic, we recommend Healy and Wahlen (1999) and Schipper and Vincent (2003). In general, this line of research has regarded earning management as opportunistic behaviors by firm managers.

On the other hand, some researchers argue that earnings management may have positive effects in terms of efficiency enhancement (Liang, 2004), but efficiency motives for earnings management has not been studied extensively in the literature. One such motive for earnings management is to convey an earnings quality signal to the market. According to Schipper and Vincent (2003), the three main dimensions of earnings quality developed in the literature are: persistence, predictability and the relative lack of variability. Earnings persistence refers to sustainability of earnings in the long run (Lipe, 1990). According to Schipper and Vincent, predictability refers to the ability of financial statements for its users to predict any item of interest in the future. Lack of variability directly implies smoothness or low variance of reported earnings. Earnings management can help reduce the variability of earnings, or to avoid missing analysts’ forecasts, it will increase the persistence and predictability of its earnings. Thus, when investors perceive the above three aspects of earnings as indicators of quality, earnings management can enhance the perception of earnings quality for a firm.

High technology ventures operate in uncertain environments both in terms of technology commercialization and market acceptance. In the biotechnology sector, ventures are engaged in a very specific and risky product development process – drug discovery and development. This process represents a significant investment of resources with little assurance of successful commercialization. Given the expensive and exhaustive drug discovery and development process, most of the biotechnology ventures are pursuing a very
limited number of drug candidates. Thus, the termination of one drug, particularly during clinical trials, represents a major adverse event and will significantly impact these firms' future value, even their survival. Under such conditions, earnings management may be very important from external stakeholders' point of view because of the high level of uncertainty about the long term cash flow generating capacity of a firm. We, therefore, expect that earnings management will have a significant effect on the negative market reaction to adverse economic events because the uncertainty in future cash flows is further compounded by the adverse event.

In this study, we focus on two aspects of earnings management: earnings smoothing and earnings management aggressiveness. In the next sections, we discuss the hypotheses pertaining to their buffering effects on the negative market reactions to adverse events.

**Earnings smoothing and adverse events.** If the firm had been smoothing its earnings over a period of time before the event, it could possibly be to smooth the compensation of its executives. If the market is efficient, it should be able to see this opportunistic strategy by the managers as a manifestation of greater agency problem in the firm relative to its peers, and should penalize the firm's value for it.

Alternatively, it could serve as a strong signal about the persistence of the firm's future earnings in line with its past earnings. In the presence of asymmetric information between managers and shareholders, the use of smoothness of earnings to convey higher earnings quality or managerial expertise may prevent a market overreaction to the adverse event, even though the stand-alone economics significance of such smoothness might not be there. So, we postulate that the market will react differently to firms that smoothed earnings prior to the adverse event, compared to those that did not. Given the competing arguments for and against earnings smoothing being in the best interest of the shareholders, we do not assume a sign for that difference.

**Hypothesis 1:** Firms with smoother earnings prior to an adverse event will have a statistically significantly different market reaction to the adverse event.

**Earnings management aggressiveness and adverse event.** Earnings management aggressiveness captures the size of managerial discretion used in reported earnings (Bhattacharya, Daouk, and Welker, 2003; Biddle and Hilary, 2006; Leuz, Nanda, and Wysocki, 2003). It reflects the magnitude of earnings management in a firm. All of the existing studies looked at earnings aggressiveness from the managerial opportunism point of view, hence the term earnings aggressiveness that usually evokes negative connotations.

However, under certain circumstances, aggressive earnings management may be used as a possible means towards a goal that is motivated by greater efficiency. For example, managers may manage earnings aggressively to achieve greater smoothness of earnings, to meet analysts' forecasts in turn, to increase the perception of greater earnings forecastability, to avoid violating debt covenants, or to reduce variability of reported earnings. All of these outcomes are very important for a firm operating in a very uncertain environment due to factors such as uncertainty of product development, lack of diversification in its product offerings, or very high product development cost. We, therefore, take a similar neutral stance towards the direction of the market reaction to adverse events for firms with aggressive earnings management before the event:

**Hypothesis 2:** Firms with more aggressive earnings management prior to an adverse event will have a statistically significantly different market reaction to the adverse event compared to those who did not manage earnings in a similar way.
Methodology

Data Collection
All the drug termination events were collected from the Recombinant Capital Database (RECAP), a comprehensive database of corporate news in the biotechnology industry gathered from press releases and SEC filings. Our sample covers the time period from January 1992 through January 2003 in the United States. Due to the data availability, we limited our sample to drug terminations by publicly traded biotech companies and collected announcement dates from RECAP, Lexis-Nexis, and press releases on companies’ websites. We then obtained daily stock return data from the Center for Research in Security Prices (CRSP) files. Our final sample consists of 98 events. Other accounting and financial variables were collected from COMPUSTAT.

We postulate that the market will react differently to firms that smoothed earnings prior to the adverse event, compared to those that did not.

It is important to note here that our sample size is limited by the nature of the setting. We captured all the drug termination events during the five year period studied. A longer time period would increase the probability of biased results due to other confounding effects. On the other hand, not all drug development activity takes place in public companies, so we are further restricted by lack of available data for all the drug termination events in the sample. Given these constraints, we still feel that our chosen set-up provides a unique opportunity to study investors’ perception of earnings management, and we proceed with the analysis with this relatively small sample size. We plan to extend our work to a larger sample size of adverse events in a future study.

Measures

Dependent Variable—Market reaction. We measure the impact of economic uncertainty through cumulative abnormal returns (CARs) around a negative shock to the firm, which in this case was the termination of a clinical trial for a drug developed in our sample. We used standard event study methodology to examine the stock market reaction to the announcement of a drug termination. Two event windows were applied to calculate cumulative abnormal returns (CARs) over the period around the announcement date. The variable CAR,-1,+1 is the cumulative abnormal return over the three-day period including the day before the announcement, the announcement date, and the following day. The variable CAR,-5,+5 is the cumulative abnormal return over the eleven-day period including five days before and five days after the announcement.

Results for the event study illustrate that the CARs and the ratio of negative to positive returns are significantly negative, and highly significant at the 0.001 level in both the (-1, +1) window and the (-5, +5) window. The mean CAR for the firms in our sample in the period of three days surrounding the adverse event is -18%, indicating that the typical venture’s value decreased 18% more than market average during the period. The mean CAR for the event window of eleven days is -17%. These results indicate that the market reaction to an adverse event at a biotechnological firm is strongly negative.

Independent Variables—Earnings Smoothing.
To measure earnings smoothing, we adopted our measure from Eckel (1981). If a firm is smoothing its reported earnings then the coefficient of variations (CV) of change in earnings will be lower than that of change in cash flows. We constructed a firm level measure of relative variability of cash flows versus income as:

\[ IS = \text{Absolute}\left(\frac{CV_{\Delta CF}}{CV_{\Delta Income}}\right) \]  (1)
where IS stands for income smoothing, Δ represents change, CF stands for cash flow and Absolute represents absolute value. If the value of IS is higher, it means that the variability of change in cash flows in standardized terms is higher than the variability of change in income, indicating income smoothing. We measured cash flows as operating cash flow from continuing operations and income as earnings before extraordinary items and discontinued operations. The averages and standard deviations were calculated over the past five years of each firm’s history ending in the last fiscal year immediately before the adverse event year. We then compared IS with median IS value for the respective quartile in the firm’s SIC3 group, where the quartiles are based on lagged ROA. We created a dichotomous variable called Income Smoothing, which was set equal to 1 if the IS value for the firm was higher than that of the performance adjusted industry median; otherwise, a value of zero was assigned.

**Independent Variables — Earnings management aggressiveness.** We use discretionary accruals scaled by lagged total assets as our measure of earnings management aggressiveness. Accruals represent the difference between cash flow and reported earnings. We used the modified version of Jones’ (1991) model to estimate discretionary accruals. Since management has a large degree of control over the creation and collection of receivables, Dechow, Sloan, and Sweeney (1995) suggested that the normal level of discretionary variables should be estimated as a function of change in sales, which is net of change in receivables. The resulting model is widely known as the Modified Jones model in the accounting and finance literature.

Following Cornett, Marcus, and Tehranian (2008), we defined total accruals as earnings before extraordinary items and discontinued operations, minus operating cash flow from continuing operations. The modified Jones model relates non-discretionary accruals to change in sales (net of change in receivables) and gross plant and property through the following regression:

\[
\frac{TAcc_t}{TA_{t-1}} = b_1 \frac{TAcc_{t-1}}{TA_{t-1}} + b_2 \frac{(ΔSales_t - ΔRecv_t)}{TA_{t-1}} + b_3 \frac{PPEG_t}{TA_{t-1}} + ε_t
\]

In the equation above, \(TAcc_t\) denotes total accruals computed at time \(t\), \(TA_{t-1}\) represents lagged total assets, \(ΔSales_t\) and \(ΔRecv_t\) denote changes in sales and total receivables, respectively. \(PPEG_t\) stands for total gross property, plant, and equipment at time \(t\).

The residuals from the above regression represent discretionary accruals (DA). We implemented the above model year by year on a cross-section of all firms in each of the three-digit SIC code groups for which we have enough data in COMPUSTAT to calculate the relevant variables. For each SIC3-fiscal year group, we subdivide the firms in quartiles based on lagged ROA. For our study, we used a dichotomous variable for earnings aggression that was set equal to 1 if the DA for a firm was higher than the median DA of the SIC3 lagged ROA based quartile for the firm during the fiscal year before the adverse event; otherwise, a value of zero was assigned.

As mentioned before, the most widely used measures of earnings management such as the ones used in this paper, smooth earnings and discretionary accruals, can occur in the routine operations of a firm due to factors such as the nature of the product it sells, industry norms related to account receivables, accounts payables, etc. So we converted the levels of our independent variables into dichotomous variables that group our firms into earnings manager or otherwise with respect to the industry it operates in. The practice of using industry medians as benchmarks for earnings management variables is a very well established tradition in the accounting and finance literature, and we chose not to deviate from it.
The fact that we used dichotomous variables instead of the underlying levels of our measures might be of concern to some readers, but there is support for this method in the existing literature. For example, Leuz et al. (2003) measured earnings management along four dimensions (including the two measures used in this study) over a sample of international firms in order to study the relationship between earnings management and investor protection. They then created an overall earnings management score for each country by taking an average of the rank of each country along each of the earnings management dimensions studied. Similarly, earnings smoothing literature has a long tradition of categorizing firms as smoothers and non-smoothers based on measures similar to the ones used in this study and then analyzing the difference between these groups along the variables of interest (for example, Eckel 1981; Bao and Bao 2004). We are constrained by our small sample size in the current study. A bigger sample size would have allowed us to make finer distinction between levels of earnings management and its impact on market value of a firm in the face of an adverse event.

Controls. The previous studies have suggested that some firm characteristics may affect the impact of an adverse event (e.g., DeCarolis et al., 2009). Thus, we include six control variables in the regressions, including firm age, total assets (firm size), ROA (firm profitability), current ratio (firm slack), the number of strategic partners and the number of products in the pipelines (firm scientific/technological resources).

The year of incorporation was obtained from the S&P database, and we calculated firm age at the time of the termination announcement. The average age for the firms in our sample is 13.10 years old. The data of total assets and ROA were obtained from the COMPUSTAT database for the fiscal year prior to the announcement. On average, these biotech firms had $468.53 million in assets, and negative 29% return to assets. The current ratio for the firms in our sample came from the COMPUSTAT database. The average current ratio in our sample is 8.36.

Our results show that the impact of earnings smoothing may last longer than that of earnings aggressiveness.

Similar to DeCarolis et al. (2009), we used two variables to control the impacts of scientific/technological resources in the final model: the number of strategic partners and the number of products in the pipeline. The number of strategic partners is counted according to the firms’ 10-K filing within the year prior to the announcement of drug termination. On average, the firms in our sample had 6.28 strategic partners when the adverse event occurred. The number of products in the pipeline is a common indicator of technological competence or expertise in the biotechnology industry (DeCarolis et al., 2009; DeCarolis and Deeds, 1999; Deeds, et al., 1997). In the study, the variable includes the total number of products that were in phases one, two, or three before the time of the event, and the mean in our sample is 6.29. The data were collected from RECAP.

Results

Table 1 shows descriptive statistics for the variables in our models. We also examined the correlation between the major variables in the regressions. The correlation matrix indicates that earnings aggressiveness is positively related to CAR(-1, +1) (p<.01), and earnings smoothing is positively related to CAR(-5, +5) (p<.05). Both of the results are consistent with our hypotheses. In addition, several control variables show significant correlations with CAR (-1, +1) and/or CAR(-5, +5), including firm total assets, firm ROA, the number of strategic partners, and the number of total product in the pipeline (p<.01). These correlations are not surprising, given that firms with more
resources would be more likely to navigate through adverse events (DeCarolis, et al., 2009). Likewise, there are significant correlations among firm age, total assets, ROA, the number of strategic partners, and the number of total product in the pipeline. However, none of the correlations are high enough to warrant concerns about multicollinearity.

Table 1: Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>N</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Max.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CAR (-1,1)</td>
<td>98</td>
<td>-0.18</td>
<td>-0.10</td>
<td>0.25</td>
<td>-0.894</td>
<td>0.279</td>
</tr>
<tr>
<td>2. CAR (-5,5)</td>
<td>98</td>
<td>-0.17</td>
<td>-0.12</td>
<td>0.25</td>
<td>-0.925</td>
<td>0.555</td>
</tr>
<tr>
<td>3. Firm age</td>
<td>98</td>
<td>13.10</td>
<td>12.00</td>
<td>5.07</td>
<td>3</td>
<td>28</td>
</tr>
<tr>
<td>4. Log (Total assets)</td>
<td>98</td>
<td>5.035</td>
<td>4.803</td>
<td>1.568</td>
<td>1.173</td>
<td>8.042</td>
</tr>
<tr>
<td>5. ROA</td>
<td>98</td>
<td>-0.29</td>
<td>-0.20</td>
<td>0.41</td>
<td>-222.47</td>
<td>20.716</td>
</tr>
<tr>
<td>6. Current Ratio</td>
<td>98</td>
<td>8.36</td>
<td>5.53</td>
<td>8.25</td>
<td>0.707</td>
<td>52.094</td>
</tr>
<tr>
<td>7. Total Partner</td>
<td>98</td>
<td>6.28</td>
<td>6.00</td>
<td>3.61</td>
<td>0</td>
<td>17</td>
</tr>
<tr>
<td>8. Product in the Pipeline</td>
<td>98</td>
<td>6.29</td>
<td>5.00</td>
<td>5.37</td>
<td>0</td>
<td>25</td>
</tr>
<tr>
<td>9. Earnings Aggressiveness*</td>
<td>98</td>
<td>0.42</td>
<td>0</td>
<td>0.50</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>10. Earnings Smoothing*</td>
<td>98</td>
<td>0.44</td>
<td>0</td>
<td>0.50</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

+ Dummy variables

Univariate Analysis. Figures 1a and 1b show the magnitude of CARs for the two groups of firms according to the earnings management measures. Both in terms of CAR (-1,+1) and CAR (-5,+5), firms that smooth earnings and aggressively manage earnings have a less negative market reaction to the adverse events compared to those who do not. This is contrary to the result one would expect if the market perceived earnings management to be a result of agency problems or motivated by the opportunistic goals of the management.
Table 2 gives the t values for the difference in means between each set of groups. The mean CARs are statistically different between each of the four sets of comparison, which is in line with both of our hypotheses. Yet, only the mean of firms with aggressive earnings management is different from the benchmark group at 5% or lower level of significance for both CAR(-1,+1) and CAR(-5,+5). This raises the question whether this difference is due to earnings management or other variables that are more relevant for the future cash flow generating capacity of the firm, such as profitability, products in the pipeline and the number of strategic partners. So we move to the multivariate analysis of the difference.

**Table 2: Univariate Analysis of Cumulative Abnormal Returns**

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>CAR(-1,1)</th>
<th>CAR(-5,5)</th>
<th>N</th>
<th>CAR(-1,1)</th>
<th>CAR(-5,5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings Smoothing</td>
<td>43</td>
<td>-.131</td>
<td>-.113</td>
<td>43</td>
<td>-.101</td>
<td>-.113</td>
</tr>
<tr>
<td>Aggressive Earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No Earnings smoothing</td>
<td>55</td>
<td>-.213</td>
<td>-.215</td>
<td>57</td>
<td>-.232</td>
<td>-.211</td>
</tr>
<tr>
<td>Not Aggressive</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| T-statistics         |    | -1.622*   | -2.053**  |    | -2.647*** | -1.945**  |

*** Significant at the 0.01 level (2-tailed)
**  Significant at the 0.05 level (2-tailed)
*   Significant at the 0.10 level (2-tailed)

**Multivariate Analysis.** Table 3 shows the results of linear regression analysis of the impacts of earnings management on market reactions to the termination of a new drug. Model 1 is the baseline model in which the analysis is restricted to the effects of the control variables in the event windows (-1, +1). The results for control variables reveal that firm ROA and the number of products in the pipeline are significantly positively related to CAR(-1, +1) ($\beta = .366$, $p< .001$; $\beta = .207$, $p< .01$), while the current ratio is significantly negatively related to CAR(-1, +1) ($\beta = -.214$, $p< .01$). Consistent with prior research, our finding shows that firm performance and some of its technological resources may mitigate negative market reactions to the occurrence of an adverse event.

Model 2 presents the full model by including the main effect of both earnings aggressiveness and smoothing. Overall, the F-statistics for the full model is significant ($F=6.04$, $p< .001$), and significantly better than the baseline model (Model 1, $\Delta R=.068$, $p< .05$). The results pertaining to the earnings management variables provide conclusive support for our hypotheses. The coefficient for earnings management aggressiveness is $.200$ at the significant level of $.01$. Likewise, the impact of earnings smoothing is also positive at the significant level of $.01$ ($\beta = .194$).

When we regressed the variables of interest on the CARs over the window (-5, +5), slightly different results are obtained (See Table 3). The F-statistics for the full model (Model 4) is significant ($F=6.04$, $p< .001$) and significantly better
than the baseline model (Model 3, ΔR=.055, p<.05). In addition to firm ROA and the number of products in the pipeline, the number of strategic partners is significantly positively related to CAR (-5, +5) (β =.169, p<.05). But current ratio becomes insignificant. Earnings smoothing is still positively related to CAR (-5, +5) at the significant level of .001 (β =.210). The coefficient for earnings management aggressiveness is still positive, but not significant. The findings suggest that although the two approaches of earnings management have similar impacts on mitigating market negative reactions to adverse events, the duration of the impacts may be different. Our results show that the impact of earnings smoothing may last longer than that of earnings aggressiveness.

We also re-estimated Models 1 and 2 (untabulated here) using robust standard errors to address heteroskedasticity related bias in standard errors, and our results did not change materially. Finally, due to confounding effects over longer event windows, we did not find significant results for longer event windows such as CAR (-30, 30) and CAR(-90,90). We have left the long run performance aspect of our analysis to a future study utilizing a larger sample size and with more control variables for the long run analysis. We acknowledge that the lack of long run analysis is a shortcoming of this paper.

| Table 3: Results of Linear Regressions Regarding the Impacts of Earnings Management on CAR(-1,1) and (-5, 5)* |
|---|---|---|---|---|
| Variable | CAR (-1, 1) | CAR (-5, 5) |
| | 1 | 2 | 3 | 4 |
| Firm age | -0.035 | -0.082 | -0.017 | -0.056 |
| Total assets | -0.018 | -0.301 | 0.019 | -0.009 |
| ROA | 0.386*** | 0.366*** | 0.289*** | 0.287*** |
| Current Ratio | -0.153* | -0.214** | -0.059 | -0.114 |
| Strategic Partner | 0.137 | 0.126 | 0.186* | 0.169* |
| Products in the Pipeline | 0.211* | 0.207** | 0.192* | 0.200* |
| Aggressiveness | | 0.200** | | 0.138 |
| Smoothness | | 0.194** | | 0.210*** |
| R² | 0.284 | 0.352 | 0.232 | 0.287 |
| Adj. R² | 0.237 | 0.294 | 0.181 | 0.222 |
| Δ R² | | 0.068** | | 0.055** |
| N | 98 | 98 | 98 | 98 |
| F-Statistics | 6.01*** | 6.04*** | 6.01*** | 6.04*** |

* Standardized coefficients reported
*** Significant at the 0.01 level (2-tailed)
** Significant at the 0.05 level (2-tailed)
* Significant at the 0.10 level (2-tailed)
The use of discretion by management provides the market with a better estimate of the true economic value of a firm.

Discussion

In this study, we investigate the impact of earnings management on market reactions to an adverse event in high technology ventures. Building on both finance and strategic management literature, we propose that earnings management aggressiveness and earnings smoothing will create a different impact for the high technology ventures when they encounter an adverse event, such as a drug termination prior to its commercialization in the biotechnology industry.

Our results provide evidence in support of both hypotheses 1 and 2. Both earnings management aggressiveness and earnings smoothing buffer the negative market reaction to the negative event of the news of drug trial termination. The market seems to react less negatively towards firms that it perceives to have higher quality of earnings, as measured through the relative stability of its reported earnings. We interpret this result according to the efficiency motive explanation provided by Subramanyam (1996). That is, the use of discretion by management provides the market with a better estimate of the true economic value of a firm.

We did not find strong support for our hypothesis 2 pertaining to earnings management aggressiveness for the relatively longer 11 days window of the event. On the contrary, the significance of earnings smoothing increases in the longer window. In other words, controlling for earnings smoothing, aggressive earnings management does not incrementally help the longer run performance of the firm. Taken together, our results related to earnings management aggressiveness and earnings smoothing indicate that the use of discretion management is able to convey a signal of earnings quality to the market and is not perceived as signs of agency problem by the investors.

Limitations and Future Research Directions

Future research in other industries or across industries may shed more light on the relationship of earnings management and the market reaction to adverse events. Our analysis is also limited to the short term effect of strategic use of earnings management on the value of a firm. We think that the longer-term analysis of this analysis should be the subject of a separate study. Also, due to the paucity of longer term historical data on our sample firms, we could not study some other aspects of earnings management and their relationship to a firm’s ability to withstand adverse events.

References


Executive Summary

Enforcement of the Foreign Corrupt Practices Act (FCPA) has reached an all-time high. FCPA violations can result in many significant costs, both monetary and non-monetary. FCPA compliance has become a top corporate governance issue and has triggered shareholder litigation, tax investigations, and money laundering probes. While many corporate managers, financial officers, board members, internal and external auditors, and forensic accountants are aware of the FCPA’s basic objectives and mandates, many may not do an adequate job of protecting their firms and/or clients from the dangerous consequences that can result from FCPA non-compliance.

The purposes of this paper are to: (1) describe and analyze the important provisions of the FCPA; (2) make recommendations to help firms improve their compliance with the FCPA; and (3) analyze and describe bribery and FCPA case filings, sanctions, and payments (bribes).

Introduction

In January 2010, the Department of Justice (DOJ) arrested 22 employees and executives of firms in the military products industry. This was the first instance where the DOJ used FBI undercover operatives to enforce the Foreign Corrupt Practices Act (FCPA), as amended¹ (Foley and Lardner, 2010, p. 1). In April 2010, Charles Jumet of Virginia was sentenced to 87 months in prison, the longest prison term against an individual for paying bribes to former foreign government officials (DOJ, 2010). These cases are the result of the radical increase of FCPA cases during the past decade. While there was only one FCPA case pursued by the federal government in 2000, in 2009 there were 67 cases filed by the DOJ and the Securities and Exchange Commission (SEC) (see Tables 1, 2, and 3). These facts highlight the priority given to FCPA enforcement by the DOJ and SEC—a priority that is second only to the fight against terrorism (Lee, 2009, p. B8).

FCPA violations can happen easily, and when they occur there can be many significant costs. First, violations expose a company, public or private, to criminal and civil penalties and other collateral sanctions such as termination of government licenses and debarment from government contracting programs. Second, the DOJ and SEC, which share joint enforcement of the law, are now seeking disgorgement of profits secured through bribery of foreign government officials. For example, in December 2009, Siemens paid a record $1.6 billion in combined fines and penalties to the U.S. and German governments, including a criminal fine of $450 million to the DOJ.² Finally, the target of an FCPA enforcement action must consider the immeasurable costs of a decline in company share price and concomitant negative reputational effects. Individual offenders can also experience fines, prison time, and negative reputational effects.
U.S. firms need to pay close attention to several trends. First, the number of FCPA cases and the severity of penalties are increasing as the DOJ and SEC emphasize enforcement. Second, FCPA compliance will become a top corporate governance issue leading to more rigorous compliance. Third, FCPA investigations will likely trigger other actions such as shareholder litigation, tax investigations, and money laundering probes (Sulavik, 2009, p. 3). While many corporate managers, financial officers, board members, internal and external auditors are aware of the FCPA’s basic objectives and mandates, many may not do an adequate job of protecting their firms and/or clients from the dangerous consequences that could result from failure to comply with the FCPA.3

The purposes of this article are to: (1) describe and analyze the important provisions of the FCPA; (2) make recommendations to help firms improve their compliance with the FCPA; and (3) analyze and describe bribery and FCPA case filings, sanctions, and bribes (payments).

Overview of the FCPA

Two central ideas are contained in the FCPA. The first is that no entity or person may offer or pay anything of value to the official of a foreign government or certain international organizations that would cause the official to misuse power or influence to benefit a business interest of any entity or person (antibribery provisions). The second is that if any payment is made to an official, whether the purpose is proper or corrupt, the payment must be reported in the payer’s financial statements according to U.S. generally accepted accounting principles (recordkeeping and internal control provisions).

The basic elements of any FCPA bribery violation are:
1. a private or publicly traded firm or any foreign person in the U.S.;
2. who corruptly;
3. pays or offers to pay money or anything of value;
4. to a foreign official or a foreign political party or to any person while knowing that all or part of the payment will be offered or paid to a foreign official;
5. for the purpose of influencing the official to obtain, retain, or direct business to any person or to secure an improper advantage.4

Publicly traded firms are required to “make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company.”5 The recordkeeping provisions are intended to prevent three types of improprieties:
1. the failure to record illegal transactions;
2. the falsification of records to conceal illegal transactions; and
3. the creation of records that are quantitatively accurate but fail to specify qualitative aspects of the transaction (Maris and Singer, 2006). 6

No relevant requirement applies with regard to making and keeping accurate financial records.

The FCPA requires publicly traded firms to design and maintain a system of internal controls.

The FCPA requires publicly traded firms to design and maintain a system of internal controls. The SEC does not mandate any specific internal controls. Instead, the SEC articulates broad goals that controls should achieve, and it leaves the implementation of specific policies and procedures to issuers. Several factors are considered in the determination of whether a system of internal controls is reasonable under the circumstances:
1. the role of the board of directors;
2. communication of corporate procedures;
3. assignment of authority and responsibility;
4. competence and integrity of personnel;
5. accountability for performance and compliance with policies and procedures; and
6. objectivity and effectiveness of the internal audit function (Maris and Singer, 2006).

Both the SEC and DOJ have enforced the antibribery and recordkeeping/internal control provisions. The SEC brings civil actions against alleged offenders while the DOJ pursues criminal prosecutions. The recordkeeping/internal control provisions have been used to support bribery charges. Prosecution under the antibribery provisions is more difficult because it is harder to obtain evidence in a foreign setting (Deming, 2006).

FCPA Literature Review

The business literature contains a modicum of research on the FCPA. Cragg and Woof (2002) provide a detailed history of the FCPA but question the efficacy of the law. These authors maintain that the FCPA has not had a significant impact on American businesses or raised the standards of conduct on the part of American companies operating in international markets. Deming (2006) notes that the FCPA possesses two principal mechanisms to execute its purposes. The first is a prohibition on bribery of foreign officials. The second is the accounting/recordkeeping and internal control provisions. This author contends that these latter provisions have a broader reach and constitute the more potent mechanism of the FCPA. As prosecutions increase, Deming (2006) expects that the accounting/recordkeeping and internal control provisions will play a more active role than the bribery provisions.

Norton (2006) highlights how compliance with the FCPA antibribery provisions is difficult for U.S. firms doing business in China. By refusing to pay bribes, American firms lose business to companies from other nations. The author concludes that U.S. firms should establish and enforce a rigorous FCPA compliance program for all employees and agents.

The legal literature contains more published research on the FCPA than the business literature. Marceau (2007) examines how the U.S. government has departed from its previous passive enforcement approach to a more aggressive posture, with prosecutors using more novel legal theories to establish liability. The author argues that the government is overstepping the law’s bounds and “is willing to prosecute entities and individuals for conduct that is not obviously actionable under a plain text reading of the FCPA.” FCPA defendants are urged to challenge “unreasonable extensions of FCPA liability.” Baker (2010) outlines the development of the FCPA, as well as its elements, defenses, and civil and criminal penalties for violations. The article also emphasizes FCPA corporate compliance programs.

Other authors have focused on the lack of clear meaning in various parts of the FCPA law. Weinograd (2010) highlights how the FCPA exception for “grease payments” or routine foreign governmental actions contains ambiguities. The author suggests statutory reform based on a tailored monetary cap for “grease payments.” “Facilitating payments” below the monetary threshold would carry a rebuttable presumption of legitimacy. Westbrook (2011) notes that the scope of the FCPA is presently unclear. Businesses have little official guidance in designing effective compliance programs. The author suggests that several points should be clarified, including the following questions:

1. Who is a foreign official under the FCPA?
2. What constitutes an “agency or instrumentality” of a foreign government?
3. Does “anything of value” include payments made to persons other than foreign officials?
4. What constitutes “knowledge” under the antibribery provisions?
5. What kinds of facilitating payments would qualify for the “grease payments” exception to the FCPA?

6. When can the FCPA be used to prosecute a parent corporation for a subsidiary’s antibribery violation? (Westbrook, 2011).

Cohen et al. (2008) document that it remains unsettled whether the FCPA’s definition of “foreign official” includes employees of foreign companies that are owned or controlled by those firms’ governments. These authors examine the origin of the FCPA’s definition of “foreign official,” consider the definition in light of other laws and analyze the impact the DOJ’s and SEC’s interpretation has had on foreign business transactions. Lipper (2010) indicates that questions surrounding the FCPA’s intent requirement will proliferate as prosecutions increase under the law. The author stresses that courts should think harder about the unique demands that FCPA cases place on juries and defendants. Also, Congress should clean up this aspect of the statute.

Lindsey (2009) focuses on successor liability under the FCPA. Firms that overlook an inquiry into an acquiree’s potential violations of the FCPA risk liability after the deal closes. The author indicates that successor liability is a consideration in the acquisition of small as well as large firms. The article outlines steps that companies can take to avoid or mitigate the risk of acquiring an FCPA liability.

**What is the Meaning of the FCPA?**

**Anti-Bribery Provisions**

**Parties Covered** The anti-bribery provisions are broader than the accounting provisions of the FCPA. The former apply to “issuers,” “domestic concerns,” and “foreign persons” acting within the U.S. An “issuer” is a public company subject to the registration or reporting requirements of the Securities Exchange Act of 1934. A “domestic concern” is any business (including those privately or family owned) that has its principal place of business in or is organized under the laws of the U.S., its states, territories, or possessions. Officers, directors, employees, agents and stockholders of “foreign persons” are subject to the FCPA if they commit a violation while in the U.S.

A U.S. parent corporation, venture, or their personnel may be liable for the corrupt practices of foreign affiliates.

Generally, the activities of a foreign subsidiary or joint venture of a U.S. corporation are not subject to the FCPA. The U.S. government could have jurisdiction, however, over acts (and those who authorize such acts) that occur outside the U.S. if such acts trigger or cause further acts to occur within U.S. territory (Lindsey, 2009).

**Making a Payment “Corruptly”** The statute itself does not define the term “corruptly,” which presents interpretational problems. One leading case states that “corruptly” means “an offer, promise to pay, payment, or authorization for payment, intended to induce the recipient to misuse his official position or to influence someone to do so and that an act is corruptly done if done voluntarily [and] intentionally and with a bad purpose of accomplishing either an unlawful end or result, or a lawful end or result by some unlawful method or means.”

**Pays or Offers Anything of Value** Although the FCPA does not define the term “anything of value,” the law prohibits not only consummated bribes but unaccepted offers or bribes. Recent enforcement actions indicate that there are virtually no limitations on what can be considered “anything of value” (Kovacich, 2009, p. 538). The payment or offer of payment of “anything of value” includes employment of officials as consultants, expense paid travel, loans with favorable interest rates and repayment terms, golf outings, sports equipment, transportation of household...
goods, discounts, and college scholarships. The context in which a promise, offer or payment is made may be dispositive of whether something is “anything of value.”

Who is a “Foreign Official?” Under the FCPA, a “foreign official” is anyone who acts in an official capacity for a government and who exercises some discretionary authority, which includes an officer of a foreign government and even an officer in the armed forces. A “foreign official” also includes political parties, party officials, or any candidate for political office. Additionally, the term may include any person employed by a foreign government agency or a corporation or entity owned or controlled by a foreign government or a consultant, broker, or other professional who acts for a foreign government (Youngberg, 2005, p. 23).

While “Knowing” or Knowledge Requirement The anti-bribery provisions define “knowledge” with respect to conduct, a circumstance, or a result as such person being “aware … that such result is substantially certain to occur” or has a “firm belief that such circumstance exists.” Knowledge may also be established if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes such circumstance does not exist. A federal district court ruled that the knowledge requirement cannot be met merely by a failure to perform adequate due diligence. Reckless disregard of the facts is insufficient to support a finding of knowledge. Knowledge requires recklessness plus conscious disregard with the aim of avoiding the truth.

Business Nexus Requirement The business nexus element means that an FCPA violator must take some action to influence a foreign official to “obtain, retain, or direct business or to secure an improper advantage.” Congress did not define these terms but enforcement actions and limited judicial guidance support a broad interpretation. “Business” is not limited to foreign government contracts but includes any commercial activity. The SEC and DOJ interpret the FCPA broadly to include payments intended to influence any governmental decision that has a positive impact on an issuer’s business.

Facilitating or Expediting Payments Exception Congress created the “facilitating payments” exception in recognition of the fact that it is common in many countries. The FCPA itself indicates that payments to expedite routine governmental actions (e.g., obtaining permits, licenses, processing visas and work orders, providing police protection, mail pickup and delivery, etc.) are deemed a “facilitating payment.” The FCPA contains no cap on the amount of a “facilitating payment,” but those permitted have been under US $1000 (Maris and Singer, 2006, p. 587).

Affirmative Defenses The FCPA states that it is an affirmative defense if a payment, gift, or offer of payment is “lawful under the written laws and regulations” of the foreign official’s country. Recognized customs or practices within a particular nation cannot serve as a basis of an affirmative defense. It remains unclear whether the questioned conduct must be specifically allowed under local law or whether the absence of a prohibition is enough to support the defense. A second affirmative defense is “reasonable and bona fide expenditures, such as travel and lodging expenses, incurred by or on behalf of a foreign official” that are directly related to “(a) the promotion, demonstration, or explanation of products or services; or (b) the execution or performance of a contract with a foreign government or agency thereof”.

Lack of a Private Right of Action The FCPA itself contains no express private right of action. FCPA enforcement actions, however, have given rise to civil FCPA-derived lawsuits by plaintiffs, including shareholders, other governments, and business partners. In one
case, shareholder plaintiffs brought a §10b suit (under the Securities Exchange Act of 1934) after the firm’s stock price fell upon the initiation of an FCPA investigation by the SEC. Immucor agreed to settle the suit for $2.5 million. Conduct that violates the anti-bribery provisions may also give rise to a private cause of action for treble damages under the Racketeer Influenced and Corrupt Organization Act (RICO), or to actions under other federal laws.

**Vicarious Liability Under the Anti-Bribery Provisions** Generally, the activities of a foreign subsidiary or joint venture of a U.S. corporation are not subject to the FCPA. The U.S. parent may be held liable (both civilly and criminally) for the foreign subsidiary’s or joint venture’s acts if the relationship between the parent and affiliate or joint venture is legally close. Officers, directors, employees, and agents of foreign affiliates and joint ventures are not covered by the FCPA, unless they violate the law while in the U.S. A U.S. parent corporation, venture, or their personnel may be liable for the corrupt practices of foreign affiliates. The parent is not liable absent knowledge of the corrupt purpose of the payment. Criminal liability may be based on parent acquiescence to an affiliate’s corrupt payments. A vital issue is the extent to which corrupt payments made by an affiliate were documented and discussed with the parent (Marceau, 2007, p. 298).

**Accounting and Internal Control Provisions** All public companies that file Form 10-K reports must observe the accounting provisions whether or not they engage in foreign operations. Officers, directors, employees, and stockholders or agents of publicly traded firms, are also subject to the accounting provisions. The accounting provisions apply to all kinds of corporate activity, even wholly domestic activity, and the manner in which those activities are reflected in corporate records.

A U.S. publicly traded firm must ensure that any majority-owned foreign subsidiary adheres to the accounting provisions. A parent issuer may be held responsible in some cases of less than 50 percent ownership (Deming, 2006, p. 474). The SEC applies practical tests in the determination of whether an issuer controls the foreign subsidiary.

**Accurate and Complete Books and Records** Although the FCPA does not define “books, records, and accounts,” the law applies to a wide variety of corporate records. For FCPA purposes, records include “accounts, correspondence, memorandums, tapes, disks, papers, books, and other documents or transcribed information of any type....”. One federal court has observed that “virtually any tangible embodiment of information made or kept by an issuer is within the scope of the accounting provisions”. The FCPA also encompasses minutes of board of director meetings and board resolutions but does not cover every memorandum or note taken by an employee.

Transactions must be accurately recorded “in reasonable detail.” “Reasonable detail” means “such level of detail ... as would satisfy prudent officials in the conduct of their own affairs”. Parent companies have been held liable for recordkeeping inaccuracies in a subsidiary despite a lack of knowledge of any inaccuracy. One reason for this legal stance is that no scienter (intent to deceive) requirement exists to establish a willful or deliberate violation of the recordkeeping provisions.

**Internal Controls** The FCPA requires publicly traded firms to design and maintain a system of internal controls sufficient to provide reasonable assurances that transactions:

- are executed in accordance with management's authorization;
- are recorded in conformity with GAAP or any other criteria;
• maintain accountability of assets;
• permit access to assets only in accordance with management’s authorization; and
• recorded assets are reconciled with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.25

FCPA provisions relating to recordkeeping and internal accounting controls provide an almost endless series of ways for the SEC to initiate civil legal action against an issuer. When fraud or other abuses are allegedly involved, the issue arises as to whether internal controls were adequate. The standard of proof in civil actions involving these provisions is preponderance of the evidence.

**Criminal Liability** For criminal liability to attach for the conduct of third parties, a publicly traded firm must possess knowledge that the third party has circumvented or intends to violate the accounting provisions.26 Deliberate ignorance or conscious disregard can satisfy the knowledge requirement.27 Knowledge may reside with one person or may be the collective knowledge of various employees acting within the scope of employment. 28

The accounting provisions have been used to support charges under the anti-bribery provisions. Prosecution under the anti-bribery provisions is more difficult because of obtaining evidence in a foreign setting (Deming, 2006, p. 492). No need exists to prove “corrupt intent,” whether a “foreign official” was involved, or to demonstrate whether a promise, offer or payment was made to “obtain or retain business” or “secure an improper advantage.” The elements of an accounting violation are limited to whether the business record is covered by the accounting provisions, whether the conduct was willful, and whether the record was accurate in reasonable detail.29

**Civil Liability.** Unlike the anti-bribery provisions, a civil enforcement action under the accounting provisions does not require knowledge. An entity can be vicariously liable for actions taken by an officer, director, employee, shareholder, or agent.30 An entity can also be strictly liable for the actions of a subsidiary where it has an interest greater than 50 percent (Giudice, 2011, p. 353).

...a jury could infer corrupt intent where the evidence showed...a close temporal link between the gift of airline tickets and the approval of a contract...

**FCPA penalties**

Criminal and civil penalties can result from violation of the FCPA. A company that violates the anti-bribery provisions may be fined up to $2 million per offense and be subject to civil penalties of $100,000 per violation.31 An individual may be fined up to $100,000 per violation and imprisoned for five years for a willful violation and may be subject to civil penalties of $10,000 per violation.32

A company that knowingly violates the accounting provisions may be fined up to $25 million and face civil penalties of up to $500,000.33 An individual may be fined $5 million, imprisoned for 20 years, and face up to $100,000 in civil penalties.34

**Analysis: The Extent of Bribery and FCPA Violations**

**The Extent of Bribery**

Precise quantitative estimates of the dollar amount of bribery are impossible to obtain since neither the bribe-givers nor bribe-takers disclose the extent of their activities. The World Bank Institute has estimated that the total amount of bribes paid per year may be $1 trillion (Rose-Ackerman, 2004, ch. 6, pp. 1-2). According to Ernst & Young’s 10th Global Fraud Survey, about 23 percent of almost 1200 corporations across 33 nations admitted their organizations had been approached to pay a
bribe to retain or win business during the prior two years (Brandfon, 2008, p. 1).

Analysis of FCPA Cases

We extracted and analyzed available data on Foreign Corrupt Practices Act cases filed by the Securities and Exchange Commission (civil) and the Department of Justice (criminal) for the years 2000-2009. Tables 1, 2, and 3 highlight the number of cases filed by the SEC and the DOJ, individually and collectively, the number of cases disposed of and pending, and the number of cases against corporations, individuals and foreign corporations, monetary sanctions, and bribes paid. The number of FCPA cases filed annually escalated considerably after 2004 (Table 3). In 2005, 14 cases were initiated. By 2009, the number of cases initiated had ballooned to 67, with criminal cases filed by the DOJ being responsible for most of the increase (Tables 2 and 3). For example, in 2006, a total of seven DOJ criminal cases were filed. In 2009, that number had risen to 52, an increase of 643% in only three years (Table 2).

During the years 2000-2009, there were 232 FCPA cases initiated (Table 3). Over 80 percent of cases filed in the last decade occurred in the five years between 2005 and 2009. Cases are being vigorously pursued with more than 80 percent of cases initiated in the last ten years having been disposed of or resolved. It is also interesting to note that more cases have been brought against individuals than corporations during the years 2000-2009.

There has also been a pattern of increasing monetary sanctions in both SEC and DOJ cases during the last decade (Tables 1 and 2). Both total and mean monetary sanctions have increased considerably. In 2004, total SEC monetary sanctions were $16.4 million. By 2007, those sanctions exceeded $86 million and in both 2008 and 2009 total monetary sanctions were over $200 million. For 2008, the mean sanction was over $33 million. For 2009, it still exceeded $16 million. Total DOJ monetary sanctions climbed significantly throughout the last decade. In 2004, total DOJ monetary sanctions were just over $6 million. In 2008 and 2009, such sanctions exceeded $400 million. Mean monetary sanctions escalated from $3 million in 2004 to over $30 million in 2008 and 2009. Total SEC and DOJ monetary sanctions have increased for two reasons. First, the rise in the number of FCPA cases has increased the total monetary sanctions collected by the government. Second, the size or amount of the fines levied has also risen.

A company that violates the anti-bribery provisions may be fined up to $2 million per offense and be subject to civil penalties of $100,000 per violation.

Table 1 presents a summary of data on total and mean business obtained from bribes (value of business obtained by bribers), the amount of bribes or payments, and the mean ratio of payments (bribes) to business obtained in SEC cases. A lack of available data makes it virtually impossible to draw any conclusions about the value of business obtained from bribes for the years 2000-2004. In the second half of the last decade, a steady increase occurred in the total value and mean value of business obtained from bribes except from 2008 to 2009. This decline may be attributable to the severe global recession. Since 2005, Table 1 highlights an increase in the mean amount of bribes paid to foreign public officials. One cannot conclude, however, that more money is being spent on bribes to obtain or retain a dollar’s worth of business. One must consider the mean ratio of bribes paid to business obtained. Since 2005, this ratio has varied from 1.3 percent to over 27 percent. From 2005 to 2009, the weighted average ratio of bribes paid to business obtained is about .1533. This means that bribe givers spend just over $.15 in bribes for each $1 in business obtained or retained for SEC cases.
### Table 1 – CASES FILED BY SEC – FCPA VIOLATIONS—2000-2009

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<tbody>
<tr>
<td>Number of cases</td>
<td>15</td>
<td>15</td>
<td>21</td>
<td>11</td>
<td>5</td>
<td>3</td>
<td>1</td>
<td>5</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>Total value of SEC sanctions (in million $)*</td>
<td>209,489(13)</td>
<td>406,667(12)</td>
<td>86,351(18)</td>
<td>68,485(7)</td>
<td>35,095(5)</td>
<td>16,426(2)</td>
<td>NA</td>
<td>.661(3)</td>
<td>0.175(2)</td>
<td>NA</td>
</tr>
<tr>
<td>Average sanction (in million$)</td>
<td>16.114</td>
<td>33.889</td>
<td>4.797</td>
<td>9.783</td>
<td>7.019</td>
<td>8.213</td>
<td>NA</td>
<td>0.22</td>
<td>0.087</td>
<td>NA</td>
</tr>
<tr>
<td>Total value of business obtained (in million $)*</td>
<td>6037,370(7)</td>
<td>10759,706(8)</td>
<td>2608,965(13)</td>
<td>945,719(8)</td>
<td>151,010(3)</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>6.45(3)</td>
<td>NA</td>
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<tr>
<td>Average value of business obtained (in million $)</td>
<td>862,481</td>
<td>1344,963</td>
<td>200,69</td>
<td>118,215</td>
<td>50,337</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>2,125</td>
<td>NA</td>
</tr>
<tr>
<td>Total bribe paid (in million $)*</td>
<td>182,311(6)</td>
<td>1616,148(13)</td>
<td>86,095(18)</td>
<td>14,381(11)</td>
<td>5,622(5)</td>
<td>0,186(2)</td>
<td>NA</td>
<td>11,960(3)</td>
<td>0.669(7)</td>
<td>NA</td>
</tr>
<tr>
<td>Average bribe amount (in million $)</td>
<td>30.385</td>
<td>124.319</td>
<td>4.783</td>
<td>1.307</td>
<td>1.124</td>
<td>NA</td>
<td>NA</td>
<td>3.987</td>
<td>0.0956</td>
<td>NA</td>
</tr>
<tr>
<td>Average ratio of bribe to value of business obtained</td>
<td>0.1478</td>
<td>0.2721</td>
<td>0.1935</td>
<td>0.0133</td>
<td>0.0213</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>0.1504</td>
<td>NA</td>
</tr>
</tbody>
</table>

Note: * Figures in parentheses indicate the number of cases for which data was available.
NA – data not available
Sources: www.sec.gov; www.doj.gov; fcpa.shearman.com

### Table 2 – CASES FILED BY DOJ – FCPA VIOLATIONS – 2000-2009

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<tbody>
<tr>
<td>Number of cases</td>
<td>52</td>
<td>32</td>
<td>26</td>
<td>7</td>
<td>9</td>
<td>5</td>
<td>5</td>
<td>4</td>
<td>9</td>
<td>1</td>
</tr>
<tr>
<td>Total value of SEC sanctions (in million $)*</td>
<td>438,908(11)</td>
<td>508,889(16)</td>
<td>91,132(18)</td>
<td>8.284(6)</td>
<td>2.4941</td>
<td>3.025</td>
<td>NA</td>
<td>0.802</td>
<td>0.021</td>
<td>NA</td>
</tr>
<tr>
<td>Average sanction (in million$)</td>
<td>39.901</td>
<td>31.805</td>
<td>5.063</td>
<td>3.047</td>
<td>2.4941</td>
<td>3.025</td>
<td>NA</td>
<td>0.802</td>
<td>0.021</td>
<td>NA</td>
</tr>
<tr>
<td>Total value of business obtained (in million $)*</td>
<td>6542,504(29)</td>
<td>9582,188(21)</td>
<td>5816,416(17)</td>
<td>751,590(5)</td>
<td>112.055(3)</td>
<td>450.300(4)</td>
<td>1101.000(2)</td>
<td>2.270</td>
<td>9.0975(4)</td>
<td>NA</td>
</tr>
<tr>
<td>Average value of business obtained (in million $)</td>
<td>225,604</td>
<td>456.295</td>
<td>342.142</td>
<td>118.215</td>
<td>50.337</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>2,275</td>
<td>NA</td>
</tr>
<tr>
<td>Total bribe paid (in million $)*</td>
<td>182,280(26)</td>
<td>1161,148(13)</td>
<td>86,095(18)</td>
<td>14,381(11)</td>
<td>5,622(5)</td>
<td>0.186(2)</td>
<td>NA</td>
<td>11,960(3)</td>
<td>0.669(7)</td>
<td>NA</td>
</tr>
<tr>
<td>Average bribe amount (in million $)</td>
<td>862,481</td>
<td>1344,963</td>
<td>200,69</td>
<td>118,215</td>
<td>50,337</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>2,125</td>
<td>NA</td>
</tr>
<tr>
<td>Average ratio of bribe to value of business obtained</td>
<td>0.1478</td>
<td>0.2721</td>
<td>0.1935</td>
<td>0.0133</td>
<td>0.0213</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>0.1504</td>
<td>NA</td>
</tr>
</tbody>
</table>

Note: * Figures in parentheses indicate the number of cases for which data was available.
NA – data not available
Sources: www.sec.gov; www.doj.gov; fcpa.shearman.com

### Table 3 – SUMMARY DATA – FCPA VIOLATIONS—2000-2009

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<td>Total number of cases filed</td>
<td>67</td>
<td>47</td>
<td>47</td>
<td>18</td>
<td>14</td>
<td>8</td>
<td>6</td>
<td>9</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>Number of cases against corporations</td>
<td>17</td>
<td>30</td>
<td>29</td>
<td>7</td>
<td>8</td>
<td>6</td>
<td>0</td>
<td>3</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Of which are foreign corporations</td>
<td>1</td>
<td>17</td>
<td>6</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Number of cases against Individuals</td>
<td>50</td>
<td>17</td>
<td>18</td>
<td>11</td>
<td>6</td>
<td>2</td>
<td>6</td>
<td>6</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td>Cases disposed</td>
<td>32</td>
<td>43</td>
<td>46</td>
<td>18</td>
<td>14</td>
<td>8</td>
<td>5</td>
<td>7</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>Cases pending at end of year</td>
<td>35</td>
<td>4</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Sources: www.sec.gov; www.doj.gov; fcpa.shearman.com
Table 2 summarizes data on total and mean values of business obtained by briber givers, the amount of bribes or payments, and the mean ratio of payments (bribes) to business obtained in DOJ cases. Since 2005, the total value of business obtained from bribes rose from about $751 million to $6.5 billion in 2009. The mean value of business obtained from bribes increased from $37.3 million per case in 2005 to $225 million per case in 2009. The mean value of business obtained from bribes per case is lower in 2009 than in 2007 and 2008, but still significantly higher than 2005.

In 2005, the total amount of bribes paid increased exponentially compared to the early 2000s (except 2004). Total bribery payments then tailed off significantly in 2006 for DOJ cases. A look at total bribery payments for the years 2006-2009 shows a substantial increase but much volatility.

**FCPA Compliance Provisions**

The main reasons for an FCPA compliance program are to prevent violations prior to their occurrence, quickly detect any violations, and mitigate the penalties in the event a violation occurs. The DOJ and SEC have noted that the existence of a compliance program is a significant factor taken into account in deciding whether to bring charges, what charges to bring, and what penalties to impose (McNulty, 2006, pp. 12-16). The failure to establish an FCPA compliance program may be seen as evidence of a lack of internal controls that might in and of itself be a violation of the accounting provisions (Witten et al., 2009).

U.S. Federal Sentencing Guidelines and several FCPA settlement agreements outline criteria by which a compliance program is evaluated by the SEC and DOJ. Although these criteria are not legally binding, they provide solid guidance on the contents of an effective FCPA compliance program. These criteria include:

- Clearly stated corporate policy against violations of the FCPA, and establishment of compliance standards and procedures that are reasonably capable of diminishing the prospect of violations;
- Assignment of the responsibility for compliance oversight to appropriate senior corporate officials who report directly to the audit or compliance committee of the Board of Directors;
- Identification of high-risk countries or businesses, and performance of periodic anti-bribery audits of operations in such countries;
- Regular FCPA training for officers and employees involved in foreign projects, and for agents, consultants, and subcontractors;
- Adoption and implementation of accounting and internal controls to ensure compliance with the accounting and recordkeeping provisions of the FCPA;
- Establishment of a reporting system for officers, employees, agents, consultants, joint venture partners, and distributors to report suspected criminal conduct without fear of reprisal; and
- Adoption and implementation of procedures to ensure that the company's agents, consultants, joint venture partners, and distributors are not likely to engage in improper activities (Witten et al., 2009).

Conducting a due diligence investigation of agents, partners, or consultants of a firm that potentially violate the FCPA is one way to reduce the risk of FCPA violations. Company procedures should require that a due diligence process be undertaken before the firm enters into a relationship with a foreign agent, representative, or business partner. FCPA due diligence concerning consultants, partners, or agents should include the following elements:

- Determining the competence, expertise, and reputation of the party, as well as the party’s contacts with important government officials.
The party’s experience, education, former government or military service, family and business relationships, and reputation for honesty are important and serve as the basis for inquiry;

- Evaluate whether the proposed compensation to be paid in exchange for the services rendered or products delivered is reasonable. “Success fees” deserve special scrutiny;
- Assure the maintenance of accurate books and records by the consultant, agent, or partner;
- Contact local counsel to ensure that the proposed arrangement will not violate local law and, depending on the circumstances, contact FCPA counsel;
- Apply a common sense “smell” test to the proposed arrangement;
- Insert standard representations and warranties concerning compliance with the FCPA; and
- After due diligence is finished, prepare a file memorandum to record the due diligence steps taken (O’Melveny and Myers, 2003).

Different sources to help ascertain a consultant’s or agent’s reputation, expertise and relationships include auditing firms, law firms, the relevant U.S. embassy, the Commerce Department, the State Department, financial institutions, and possibly private investigations (O’Melveny and Myers, 2003).

Companies using foreign consultants, agents, or representatives should place protective covenants in consultancy, partnership, or agency agreements such as:

- The parties’ confirmation of an awareness of the terms of the FCPA;
- An agreement not to violate the FCPA;
- An agreement not to pay money or anything of value to foreign officials;
- A representation that the party is not an employer, officer, or agent of a foreign government or candidate for public office, and an agreement that the U.S. party will be advised if the partner or consultant assumes the position of a government official during the relationship;
- An agreement that the party will keep accurate books and records;
- A covenant that will allow the U.S. firm to review or audit all the books and records of the consultant or agent relating to its activities for the benefit of the U.S. firm; and
- An agreement that payments under any contract will be made only by check or wire transfer to an account in the name of the contracting party located in the host country (O’Melveny and Myers, 2003).

It is critical to have the appropriate tone from the top for FCPA compliance. The entity’s FCPA policies and procedures must be endorsed by both senior and mid-level management. The latter are important because they actually conduct the firm’s daily business operations. Each entity should also conduct periodic reviews of its FCPA compliance program, with a view toward remedial action so that any missteps are not repeated. Continuous monitoring for FCPA compliance should be linked to other antifraud efforts, because a relationship exists between the way bribery is conducted and the kinds of schemes that are used for fraud (Taylor, 2009).

**Conclusion**

The FCPA now plays a pivotal role in addressing U.S. firms’ involvement in bribery of foreign public officials and requiring that publicly traded firms meet certain standards regarding internal controls and accounting practices, books, and records. The SEC and DOJ have increased enforcement of the FCPA during the last few years, to such an extent that many publicly traded firms have FCPA audits performed by internal and/or external auditors.
The anti-bribery provisions criminalize the payment or offer of payment, either directly or indirectly, of money or anything of value to an official of a foreign government, public international organization, foreign political party or candidate for public office, made with corrupt intent to obtain or retain business or secure an improper advantage. The anti-bribery provisions are much broader than the accounting provisions.

The World Bank Institute has estimated that the total amount of bribes paid per year may be $1 trillion.

All public companies that file Form 10-K reports must observe the accounting provisions, whether or not they engage in foreign operations. Officers, directors, employees, and stockholders or agents of a public company, acting on the latter’s behalf, are subject to the accounting provisions. The latter are aimed at prohibiting the establishment of off-the-books accounts, making of off-the-books transactions, recording of non-existent expenditures, and the use of false documentation for concealing bribery activities.

The FCPA also requires publicly traded firms to design and maintain a system of internal controls. Although the SEC does not mandate any specific controls, it does articulate broad goals that controls should achieve, and it leaves the implementation of specific policies and procedures to issuers.

FCPA compliance programs are a key means to demonstrate cooperation in the event of a violation. A firm’s board of directors and senior management should establish a compliance culture through preventive training and ongoing monitoring. Specific audits focused on the FCPA have become more common in many firms.

In sum, the FCPA and its enhanced enforcement represent an important step towards combating bribery in international business transactions and promotion of more transparent financial reporting. Increased enforcement of the FCPA should result in a reduction of the level of corruption and fraud. Only then will the global marketplace become a level playing field that embraces the principles of fairness and transparency and promotes confidence in the arena in which international and securities transactions occur.

Endnotes


3 A staggering 52 percent of American corporate leaders know little or nothing about the FCPA according to Ernst & Young’s 10th Global Fraud Survey (Brandfon, 2008). In fact, according to a survey from Deloitte LLP, only 32 percent of 620 responding firms increased internal controls to prevent FCPA violations despite higher fines, more prison sentences, and more frequent prosecutions.


6 Corporate records must include information that would alert the SEC to any possible impropriety. These provisions permit the SEC to uncover irregularities that would not normally be apparent under the existing accounting systems (Maris and Singer, 2006).
The federal appellate court found that a jury could infer corrupt intent where the evidence showed: (i) a close temporal link between the gift of airline tickets and the approval of a contract; (ii) a close relationship between the recipient of the gift and influential government officials; and (iii) a classification of the gift by the giver as a commission in company records.

References


Chasing Islamic Finance: A Framework to Assess the Potential Benefits of Australian Tax Reforms to Facilitate Islamic Finance

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Executive Summary

Based on recommendations by the Australian Financial Centre Forum, the Australian government is pursuing an agenda of reforms to provide for greater facilitation of Islamic finance – the banking and finance systems based on Islamic beliefs (Sherry, 2010; Bowen, 2009). It has been argued that the greater facilitation of Islamic finance is critical for Australia to achieve its aspiration of becoming a financial services hub (Australian Financial Centre Forum, 2009). Potential tax reforms are seen as a critical part of this facilitation (Board of Taxation, 2010). However, what are the potential benefits of Islamic finance for Australia?

This paper sets out to provide a framework of analysis so the arguments for tax reforms can be considered. The framework considers the dynamic factors of national interest, legal compatibility, equity and neutrality, fiscal, constitutional, regulatory, political and social considerations. It is only on such a comprehensive framework that due consideration about the future of reforms for Islamic finance can be assessed.

Introduction

The emergence of Islamic banking and finance (referred to as ‘Islamic finance’) is a relatively new phenomenon in global financial markets (Van Greuning and Iqbal 2008). Essentially, it refers to banking and finance systems whose financing models and operations are based on Islamic beliefs (shariah law) in direct contrast to banking and finance systems whose models and operations are based on secular principles (referred to as ‘conventional finance’) (Yaqubi, 2005).

In recognizing developments in global financial markets, the Australian government has tentatively sought to facilitate the entry of Islamic finance in Australia. To this end tax reforms that may result in positive economic outcomes have been recommended as being necessary. Particularly, following the recommendations of the Australian Financial Centre Forum (Australian Financial Centre Forum, 2009), the Australian government announced that the Board of Taxation would undertake a comprehensive review of Australia’s tax law in order to identify impediments in the current law against the development and provision of Islamic finance, banking and insurance products (Sherry, 2010). More recently the Board of Taxation released a ‘Discussion Paper’ inviting submissions in regards to its terms of reference in pursuance of that brief (Board of Taxation, 2010).

In particular it has been suggested that reforms are necessary if Australia is going to
realize the stated policy goal of becoming a financial services hub, particularly in South East Asia (Australian Financial Centre Forum, 2009). However, how can the case to justify tax reforms in Australia be assessed? This paper seeks to provide such a framework of analysis to which the arguments for reforms can be analyzed.

The paper is structured as follows. Firstly, the meaning and principles of Islamic finance will be canvassed, and its growth in global financial markets. Secondly, reflections on potential tax anomalies with Islamic finance products will be discussed. Then a framework will be outlined and discussed. The framework will consist of the notions of: national interest; legal compatibility; equity and neutrality; fiscal, constitutional, regulatory, political, and social considerations. It is against this framework that the arguments for reforms to facilitate Islamic finance will be considered.

It will be argued that while the direct benefits of Islamic finance may be limited – the facilitation of faith-based financial products (such as Islamic finance) is an important component of Australia becoming a financial services hub.

**The Meaning and Size of Islamic Finance**

Islamic finance may be conceived as an economic system premised on ethical rules and norms that, when properly practiced and adhered to, are intended to satisfy a moral purpose. The ethical rationale is compliance with the *shariah* (Islamic law) (Yaqubi, 2005). The corpus of the *shariah* emanates from its primary canons, namely the Qur’an and the prophetic traditions (*hadith*). These sources underpin the law on financial transactions and are complemented by independent legal decision-making (*ijtihad*) in the form of analogical deductions, legal precedents, presumption of continuity and juristic consensus (Doi, 1984; Kamali, 2004). As such, the *shariah* sets parameters within which Islamic finance may endure, such as: recognizing the use of money and capital as a means of exchange and not a tradable commodity; prescribing acts that are lawful, and those that are prohibited (al-Qaradawi, 1984); defining the relationship between risk and profit (El-Gamal, 2009) and setting out the social responsibilities of parties in financial dealings (Vogel and Hayes, 1998). One principle is freedom from *riba* (interest) in Islamic financial products.

Compliance with these principles had led to the development of a number of Islamic financial products, some of which share characteristics to those used conventionally. Some of the Islamic finance products include: *murabaha* (cost-plus) financial transactions; *ijara* contracts (leasing contracts); *mudarabah* contracts (trustee partnership); *musharaka* contracts (forms of limited partnership); *sukuk* (Islamic bonds), and *takaful* (mutual insurance arrangement).

Islamic finance is estimated to be worth more than A $1 trillion (U.S. $822 billion) (The Banker, 2009) – with growth estimated by the International Monetary Fund (IMF) (IMF, 2007) at between 10-15 percent annually and expanding (Standard and Poor’s, 2009). Currently, most Islamic financial services are facilitated through a combination of pure Islamic banks, conventional western banks with Islamic windows, and hybrid institutions offering both conventional and *shariah*-compliant banking and investments (Australian Financial Centre Forum, 2009). A large proportion of Islamic finance activity is comprised of issuances through the Islamic bond (*sukuk*) market, with global sukuk issuances totalling U.S. $30.94 billion in 2007 and U.S. $23.6 billion in 2008 (Millikan, 2009). Under-utilized oil revenue, sovereign wealth institutions and private investment portfolios of high net-worth families and individuals drive much of this capital market activity (Nathif and Abdulkader, 2005).
The current reach of Islamic finance in global capital and equity markets suggests there is potential for Australia, through multi-lateral trade and financial services, to facilitate Islamic finance by expanding opportunities within and beyond its borders (Australian Financial Centre Forum, 2009). However, Australia’s tax laws have been identified as one of the potential burdens for the expansion of Islamic finance.

Islamic finance is estimated to be worth more than A$1 trillion (U.S. $822 billion) – with growth estimated by the International Monetary Fund at between 10-15 percent annually and expanding.

Tax Anomalies with Islamic Finance

Complying with the strictures and principles of shariah law means that an Islamic financier may have an ‘equity’ compared to a ‘debt’ investment with a financed project. That is, the Islamic financier participates as an equitable partner in the project or venture, with an entitlement to a share of ‘profit,’ as opposed to investing by way of a debt obligation that often promises capital guarantee and interest returns. Also ownership of a financed asset may be shared between the financier and the borrower, with the borrower over time gaining a greater ownership interest.

This participation by the Islamic financier can lead to tax anomalies due to differing treatment of equity and debt for Australian tax purposes. For example, returns on equity, such as dividends, are generally non-deductible for the entity making the payment. In comparison, returns on debt are normally in the form of ‘interest,’ which is of a revenue nature and therefore more likely to be deductible (depending upon the precise use of the borrowed funds). Also problematic may be the timing and the quantum of when the Islamic financier has to realize income.

With conventional finance it has been observed that the financier does not normally ‘participate in the project or enter into trade with the borrower’ (Savona and Mofakhami, 2009). Instead, the conventional financier receives a return or reward for the funds provided to the borrower in the form of interest. This interest is payable regardless of the success of the endeavour – that is, there is no contingency of the borrower’s obligation to pay. Furthermore, the conventional financier does not normally own the underlying assets being financed; instead, the financier is able to protect its position and minimize the risk of default by taking various securities (Savona and Mofakhami, 2009). For instance, the conventional financier could take a registered security interest – such as registered mortgage over real property – to ensure preferential realization of the security against competing creditors. Other securities could be in the form of a fixed and floating charge over business assets and personal guarantees.

The prohibition of interest (riba) means that the use of loans as a financing device is not available for an Islamic financier. It is important to acknowledge that there is some overlap between the financial products used by conventional and Islamic financiers – such as hire purchase arrangements. However, the Islamic financier is restricted to the variety of products that can be used to ensure Shariah compliance. This disparity is one of the main reasons for conventional banks’ reluctance to enter the Islamic finance market proper (Ibrahim, 2010).

The different participation of Islamic financiers can lead to tax anomalies between conventional and Islamic finance for Australian tax purposes. In particular, is the ‘profit charge’ embedded in an Islamic financial product deductible in a similar manner to interest charged by a conventional financier? Also, do Double Tax Agreement (DTA) Treaty concessions for international payments of
interest apply to this profit charge – or is the profit charge subject to higher rates of tax impost? Furthermore, if the Islamic finance product allows for the staged transfer of an asset, what are the capital gains tax and stamp duty outcomes of this?

It is for these reasons that Australia’s current tax system is seen as problematic for the expansion of Islamic finance. However, should the Australian government be concerned that there can be inadvertent tax impost for taxpayers under Islamic finance arrangements? It is argued that it is imperative that a framework of understanding be utilized to assess whether tax reforms are justified.

A Framework for Tax Reform

Why should reforms proceed? It is argued that the need for reform is driven by a combination of reasons of which the requirement for tax parity is a significant element. Given the complex issues involved, the reform process may be conceptualized through a framework that reflects the collective influence of several factors as depicted in Exhibit 1.

Exhibit 1 suggests that the factors that drive tax reform (represented on the outer circles) may manifest as single or composite considerations such as: meeting the national interest criteria; law; equity; fiscal, constitutional, regulatory, political, and social considerations. The rationale of this framework is that faith-based considerations alone cannot determine changes to tax law – the necessity must be driven by a combination of core considerations (represented in the inner-circle) based on ‘need and urgency and circumstances.’

Exhibit 1. A framework for tax reform
In shariah law, an Islamic financier ... participates as an equitable partner in the project or venture, with an entitlement to a share of ‘profit,’ as opposed to ... capital guarantee and interest returns.

Drivers of tax reform

The following is a discussion of each of the drivers for reform outlined in the outer boxes of Exhibit 1.

Any reform of tax law must in the first instance meet the ‘national interest’ criteria, which refers to the notion that the reform must benefit the nation as a whole and not just a select group. The national interest is best served if anticipated changes enhance economic value and creates social good. This results-based argument suggests (for example) that tax changes resulting in net private investment in the economy serves the national interest, such as providing more efficient debt/equity alternatives of addressing housing finance.

The ‘legal compatibility’ driver advocates that proposed changes to tax law must be accomplished within the existing legal framework with minimal adjustments. This refers to reforms that are required to rectify anomalies or uncertainties.

The ‘equity and neutrality’ consideration refers to the concept that fairness and justice must prevail. Changes may be conceived as equitable if they result in non-discriminatory outcomes. For instance, changes to facilitate ‘ijara’ (Islamic lease) financing should not impinge on current treatment of lease arrangements and must result in tax neutral outcomes.

‘Fiscal’ considerations relate to reforms that do not result in revenue loss and that revenue-positive outcome may be achieved through increased economic activity. That is, the net effect of facilitating Islamic finance ought not to result in revenue leakage but carry the potential to raise additional revenue through competition and innovation. Such considerations are necessary as some reforms may initially result in too high ancillary costs – for example, increased administrative costs.

The ‘constitutionality’ consideration refers to the requirement that the proposed changes must be consistent with the Australian Commonwealth.

The ‘regulatory’ consideration argues for a ‘whole-of-industry’ approach in the sense that Islamic financial practices must conform to requirements administered by the Australian Securities and Investment Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Reserve Bank. This factor also suggests that reforms could be implemented by legislation or administrative power granted to a Minister or delegated through government agencies.

The ‘political’ factor acknowledges that in the democracy professed in Australia, there are various political factors at work, including the ideology of various parties, people and groups. Thus, even if Islamic finance may be touted as essential to Australia for political expediency, that desire must first satisfy the ‘national interest’ criteria. It is essential, therefore, that the facilitation of Islamic finance is not one driven by the need to appease a section of the population. For this reason, the ‘social’ factor must ensure that social needs reflect the desire of the whole community, and not be predicated on religious beliefs only.

Relationship between drivers of reform and tax imperatives

It is argued that one or a combination of the drivers may determine whether tax reform should be pursued. However, the imperatives for reforms must be driven by the core considerations of ‘need’, ‘urgency’ and
Chasing Islamic Finance: A Framework to Assess the Potential Benefits of Australian Tax Reforms to Facilitate Islamic Finance

‘circumstances’ (represented by the inner circle in Exhibit 1).

‘Needs’ refer to the requirement and maintenance of a sound and efficient tax regime in which every taxable entity must contribute towards the fiscal revenue (Smith, 1789). ‘Urgency’ refers to time criticality for changes to be implemented (Henry, 2008). ‘Circumstances’ refers to the economic and financial circumstances in which Australia finds itself, in terms of the global economy and financial markets (Australian Trade Commission, 2010). It also encapsulates social realities and the demands for tax changes driven by domestic and foreign complexities in the world: for example, combating social exclusion (International Financial Services, 2008).

Tying all these considerations together, the ‘needs and urgency’ consideration suggests that the national interest is served by making Australia more dominant in global markets and maintaining a competitive edge over rivals. Also, attracting Islamic finance from overseas should be seen to provide openness and flexibility to ensure a strong revenue base for growth and prosperity. This is evident from the following facts. As previously outlined, it is estimated that Islamic finance is worth more than U.S. $822 billion with estimated growth over 10% annually. Globally, shariah-compliant assets are projected to reach U.S. $1 trillion in 2010 and U.S. $1.6 trillion by 2012 (Wyma, 2009), with the Islamic bond (sukuk) market accounting for a large proportion of this (Millikan, 2009).

In relation to the ‘circumstances’ consideration, the openness to global markets for Australian financial services will be stymied if present financial skills are unable to compete. Furthermore, given the fluidity of capital markets, if Australia does not implement timely tax reforms, then a significant proportion of potential Australian-centred Islamic finance is likely to flow elsewhere – possibly to more tax friendly jurisdictions. The current reach of Islamic finance in global capital and equity markets suggests there is potential for Australia, through multilateral trade and financial services, to facilitate Islamic finance by expanding opportunities within and beyond its borders. Potential economic benefits include, but are not limited to, Islamic stand-alone banking operations in Australia; capital raising in foreign markets; managing, lead underwriting and maintaining books of shariah compliant securities for new issue; exporting specialist financial services, as well as conventional banks providing shariah-compliant investment and financing products across the Asia Pacific and Gulf regions. Also, investment in Australian assets and business by overseas shariah investors may be facilitated particularly from ‘petrodollar liquidity’ (Crean, 2010). This ‘liquidity’ refers to oil rich nations’ domestic economies being too small to absorb all capital inflows from oil revenues, thereby allowing them greater opportunities to invest their excess liquidity elsewhere. Other opportunities relate to services provided to, and investments made by, shariah-compliant managed funds. It has been observed that the notion of Australia emerging as a regional financial hub may be possible due to a number of inherent characteristics of Australia’s current financial market. For example, 7.5% of Australia’s Gross Domestic Product (GDP) is made up directly of finance and insurance sectors (Australian Financial Centre Forum, 2009). Furthermore, in terms of free market capitalization, Australia’s equity market ranks seventh in the world, and second within the Asia area. However, a further consideration is that the current tax system makes it unattractive for foreign capital to flow into Australia, as more attractive tax changes have been introduced by the United Kingdom and Malaysia in terms of Islamic finance.

In relation to the ‘legal compatibility’ consideration, there is currently a need for equal tax treatment of Islamic vis-a-vis
conventional finance contracts. While it may not be urgent, the longer reforms take, the greater the probability that other jurisdictions may gain greater competitive advantage. This argument is premised on considerations that payments on ‘profit participation loans’ in Islamic equity products are now treated as ‘finance charges’ in many jurisdictions. If equivalent treatment is not implemented, then investment inflow could be lost. The ‘circumstances’ argument is that the cost of debt finance is deductible for conventional finance, while ‘profit’ distribution in Islamic finance is not deductible, even though it may be argued that economically similar outcomes are achieved. That is, while the form of the finance transactions may be different, the substance of the transactions over time is similar. Such tax asymmetry led to reforms in Australia to encourage private equity investment through tax transparency for venture capital.

Any reform of tax law ... must benefit the nation as a whole and not just a select group.

The relationship between the ‘equity and neutrality’ considerations to the ‘needs and urgency’ concepts in Exhibit 1 are that the economic outcomes of Islamic finance must be similar to conventional finance. However, because they are structured differently the Australian tax impost can be greater. It is preferable that reforms are introduced to improve tax neutrality, as this discrepancy is accentuated when international finance is involved. The need for Australia to respond to this trend is compounded as there is an increase in the international integration between a country’s economy with financial capital that is largely internationally mobile (Quiggin, 2001). Commentators have stated that this increasing economic globalization will translate into an increasingly competitive environment for businesses, including Australian businesses (Pinto, 2002). Governments are recognized as having a key role in facilitating or inhibiting this competition. The Henry Review recently highlighted the significance of globalization on tax planning:

Increasing globalization, particularly among more developed economies means social systems and economic infrastructure are becoming more uniform and tax settings may become relatively more important in decisions about where to invest and work (Australia, 2008).

Indeed, what appears to be replacing the fear of lost revenue from international tax competition is revenue loss from an uncompetitive international tax system (Speed, 2003). This is because the poor coordination of countries’ tax systems can produce international double taxation through asymmetrical tax treatment (Radaelli, 1999). This is of concern, given the previous discussion about the disparity between equity and debt in Australia.

Furthermore, for a capital-importing country such as Australia, it is important to realize that it is inefficient to levy a tax burden on factors of production which are in perfectly elastic supply (Sorensen, 1998). One such elastic factor is capital. Due to the mobility of capital, breaches of import-export neutrality may lead to unduly high levels of overall tax, which could lead to capital being invested elsewhere. For example, the higher level of tax imposed on equity returns as opposed to interest, illustrates how the ‘cost’ of investing into Australia could be considered to be too high. Investment capital is more mobile and more sensitive to tax asymmetries and tax arbitrages. Capital is then seen as having no ultimate loyalty to any country or community, with its main purpose to generate profits (Sikka, 2008). It is this ‘elasticity’ that is an important consideration in terms of facilitating Islamic finance in Australia.

Both large and small countries can no longer set economic policies without considering,
firstly, how their decisions affect others, and secondly, how the decisions of others affect them (Hallerberg and Basinger, 1998). This may mean economic choices being severely constrained by decisions which are taken outside countries' borders (Owens, 1993). Owens argues that this greater interdependence between countries could severely limit the freedom of domestic policymakers to determine their own economic policies irrespective of what is happening outside their borders.

What this means is that globalization demands a much more pro-active and ongoing process of tax reform than has been practiced in the past. The Australian Government needs to consider whether its tax system results in unforeseen asymmetrical tax treatment (Ernst and Young, 2002). For this reason, Swank and Steinmo argue that policy makers face intensifying pressure to reform tax policies to promote tax neutrality in terms of import-export neutrality (Swank and Steinmo, 2002). This goal has led some commentators to state that economic policies across countries have begun to converge (Hallerberg and Basinger, 1998).

The need for equity and neutrality means that changes to facilitate Islamic finance must not result in unequal tax burdens; taxes must be distributed in an equitable fashion with no taxpayer made worse off by making some better off. New tax laws must apply equally to all transactions of the same genus regardless of whether they are shariah compliant or not. Of particular importance is that there must be certainty of treatment, as there is currently a lack of consensus on the correct treatment of Islamic finance products under current international standards. Given such circumstances it may be noted, for instance, that pursuant to the United Kingdom’s tax reforms, ‘returns’ and income are treated as ‘as if interest’ to accommodate Islamic profit and loss concepts.

If Australia does not implement timely tax reforms, then a significant proportion of ... Islamic finance is likely to flow elsewhere – possibly to more tax friendly jurisdictions.

Much of the concessional treatment afforded to interest is due to a ‘policy of encouraging flows of capital from abroad’ and thereby reducing ‘borrowing costs for Australian businesses, (Australian Financial Centre Forum, 2009). For Australia, there is not a lot of difference in the rate of withholding tax (‘WHT’) for interest when comparing Double Tax Agreement (‘DTA’) and non-DTA countries. This may be explained by the desire to enhance Australia’s potential to be a financial services center (Crean, 2010).

In comparison, the WHT rate for dividends can vary dramatically if the non-resident is in a treaty country. However, the rate of WHT could be nil if the exemption for publically offered company debentures applies. Also, Australia’s DTA’s with a number of selected countries (the United States of America, the United Kingdom, Japan, France, Norway, Finland and South Africa) can reduce the WHT rate down to nil pursuant to the financial institution exemption (Crean, 2010). While this is good for Islamic finance originating from the United Kingdom, this means that the Islamic finance hubs of Malaysia and Singapore cannot benefit from this exemption. Nor would this benefit Islamic finance sourced from the non-DTA countries in the Gulf region.

Focusing on the ‘fiscal’ consideration in Exhibit 1, the ‘needs and urgency’ factor argues that if changes are not implemented, then an opportunity will be lost to generate a new finance source and, consequently, ongoing economic growth. Another potential benefit of Islamic finance is diversification. For example, due to the ethical aspects of Islamic finance (such as risk sharing, restriction on
short selling) Islamic finance has been viewed by some as ‘more resilient’ in the face of the Global Financial Crisis (‘GFC’) of 2008/2009 (Australian Trade Commission, 2010). Secondly, Islamic finance may provide diversification by providing better alternative sources of funding – especially when the capacity of banks to provide debt to businesses can be restricted due to the GFC placing funding pressures on institutions. Indeed, other Australians could benefit through Islamic finance providing an alternative mechanism for housing purchases. The United Kingdom’s experience demonstrates Islamic finance has contributed to the real economy through choice and diversity and the financial potential it holds out for the future. However, it should be acknowledged that reforms may lead to concerns about avoidance and/or abuse (HM Treasury, 2008).

Countries can no longer set economic policies without considering, firstly, how their decisions affect others, and secondly, how the decisions of others affect them.

The need to maintain tax efficiency means rules to facilitate Islamic finance must ensure compliance and collection costs are minimized, and that changes should aim to minimize revenue leakage. However, it should be acknowledged that not all commentators consider that significant returns would flow from the necessary investment of public monies to create the infrastructure and regulatory system to support Islamic finance – particularly if tax concessions are provided (Dabner, 2008). The ‘circumstances’ are that Islamic finance provides alternative sources of finance – an opportunity to be seized given Australia’s geographical location to a large Muslim population in Asia. Demographically, the potential for Australia is accentuated by the fact that there are over a billion Muslims living in the Asia-Pacific region. This is complemented with the high regard of Australia’s financial sector – with Australia’s financial system and capital market ranking second among 55 leading nations in 2009 (World Economic Forum, 2009).

Currently, the major centers for Islamic finance include the United Arab Emirates, Bahrain and Malaysia (Board of Taxation, 2010). However, there is significant activity occurring in the United Kingdom and other parts of Europe, Africa and Indonesia. Table 1 lists the top ten countries in terms of the value of Shariah-compliant assets, demonstrating that Malaysia is third largest, with the United Kingdom eighth. In Malaysia, prominent Islamic financial institutions include Bank Rakyat, Maybank Islamic Berhad, BIMB Holdings, CIMB Islamic Bank Berhad and Public Bank Islamic Berhad. Indeed, Malaysia and Bahrain have been credited as the most active in developing dual systems where Islamic and non-Islamic financial institutions operate alongside each other (Australian Trade Commission, 2010).

There is also the ‘need’ to ensure that proposed tax reform for Islamic finance is constitutional.

### Table 1: Top Ten Countries: Shariah-compliant assets

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<tr>
<td>1</td>
<td>Iran</td>
<td>235.3</td>
<td>293.2</td>
</tr>
<tr>
<td>2</td>
<td>Saudi Arabia</td>
<td>92.0</td>
<td>127.9</td>
</tr>
<tr>
<td>3</td>
<td>Malaysia</td>
<td>67.1</td>
<td>86.5</td>
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<tr>
<td>4</td>
<td>United Arab Emirates</td>
<td>49.1</td>
<td>84.0</td>
</tr>
<tr>
<td>5</td>
<td>Kuwait</td>
<td>63.1</td>
<td>67.6</td>
</tr>
<tr>
<td>6</td>
<td>Bahrain</td>
<td>37.4</td>
<td>46.2</td>
</tr>
<tr>
<td>7</td>
<td>Qatar</td>
<td>21.0</td>
<td>27.5</td>
</tr>
<tr>
<td>8</td>
<td>United Kingdom</td>
<td>18.1</td>
<td>19.4</td>
</tr>
<tr>
<td>9</td>
<td>Turkey</td>
<td>15.8</td>
<td>17.8</td>
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<tr>
<td>10</td>
<td>Bangladesh</td>
<td>5.7</td>
<td>7.5</td>
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For reforms to be constitutionally valid, it is critical to determine the relationship between religious freedom provided in s 116 and the Commonwealth’s power to tax under s 51 within the Australian Constitution. Even though s 116 has been interpreted narrowly, there is judicial commentary to indicate that s 116 is an ‘overriding provision applicable to all instruments of laws’ (Puig and Tudor, 2009). However, it appears that while the power to tax would be subject to an overriding prohibition of religious freedom, provided that the tax law is of general application then s 116 will not invalidate it (Freudenberg and Nathie, 2011).

Another ‘circumstance’ is that the present state of Australia’s tax law creates increased costs to entry. If legal impediments are removed it may create enforceable rights and obligations that will encourage foreign Islamic banking institutions to enter the market.

Turning to ‘regulatory considerations’, the ‘needs and urgency’ consideration is that taxation is not the only issue that must be considered to increase Islamic finance. There is need for a joint regulatory approach and strategy for the Treasury, the Reserve Bank of Australia (RBA), Australian Securities and Investment Commission (ASIC), and the Australian Taxation Office. This includes considering consumer and depositor protection and standardization of financial arrangements. For example, there could be the need to amend or clarify banking regulation, accounting reporting, application of corporations’ law investor protection, and the relationship of the boards of Islamic banks and their Shariah scholars (Australian Financial Centre Forum, 2009). Also, reform by the States will be required in terms of the application of stamp duties. This includes consideration of the insurance market, as in addition to banking, there are opportunities in the Islamic insurance market known as ‘Takaful’. Particularly, it is seen that with Australia’s number of highly regarded actuaries in the Asia-Pacific region, internationally Australia could be well placed to assess such insurance products in terms of risk assessment and underwriting.

This should, as far as practical, aim for a level playing field for both Islamic and conventional finance. The ‘circumstances’ is that there is currently, in terms of Islamic finance, a perceived lack of education, training and skills. While there is currently some Islamic finance activity in Australia, it is considered that there is currently, in terms of Islamic finance, a perceived a lack of education, training and skills. While there is currently some Islamic finance activity in Australia, it is considered that there is large potential for this to be expanded as the operations of Muslim Community Co-operative (Australia) Limited (MCCA) and submissions made by it indicate. MCCA has been providing various Islamic financial products since 1989 in Australia, and currently has approximately $425 million worth of finance written or managed by it.

The need for such pro-activeness is highlighted by the fact that other countries such as the United Kingdom, Malaysia and Singapore are already introducing reforms to their finance and tax laws to recognize and facilitate the use of Islamic finance. Other financial service providers include the Islamic Cooperative Finance Australia and Iskan Finance, both based in Sydney, that provide financial products to assist with home purchases and education expenses (Board of Taxation, 2010).

The relationship between ‘political’ drivers and the ‘needs and urgency’ considerations is that reform must be necessitated by the need to ensure economic advantage. The Austrade report demonstrates that the urgency for encouraging Islamic finance is driven by necessity and political expediency. Experience with changes to Victorian stamp duty law demonstrated a positive impact on home financing stemming from the removal of multiple stamp duty. Many countries have migrated wholly or partially toward Islamic
finance without disturbing religious norms and customs: examples include Malaysia, the United Kingdom, Singapore and South Africa. The ‘circumstances’ is that currently there is some political will to implement reforms to facilitate Islamic finance, albeit limited to small pockets of positive interest groups. However, it needs to be acutely aware that there is some fear that Islamic finance will undermine the Australian way of life largely driven by ‘Islamaphobia’. Furthermore, Australia may exert (or have exerted on it) market and prudential influence through multilateral financial engagements.

Finally, in considering the ‘social’ driver of reform, the ‘need and urgency’ consideration includes the realization that Australia has a greater diversity of religions and faiths. However, the need for change must not be exclusively for the benefit of Muslims, but for the benefit of all in society. Tax law should not differentiate between religious groups. For example, the United Kingdom tax law is specifically designed to remove this bias. In assessing tax treatment one merely looks at the tax law and not to other realities. Also the ‘need’ consideration must ensure that welfare loss is minimal. Given the housing affordability crisis in Australia, the social need for housing may be assisted through alternative Islamic financing products in assisting with housing affordability. The ‘circumstances’ are that ‘such an amendment would send a message to potential Islamic investors signalling Australia’s cultural understanding and tolerance of Islam and inviting engagement’ (Dabner, 2008).

Within Australia there is also a growing Muslim community, with 365,000 Muslims, representing 1.7 per cent of Australia’s population (Australian Trade Commission, 2010). Contextualized, there are approximately 1.57 billion Muslims world-wide representing approximately 23 per cent of the world’s population (Pew Research Centre, 2009). It is estimated that Islamic finance represents only 1 per cent of global finance. It is because of this dichotomy that commentators argue there is potential for growth (Australian Trade Commission, 2010). These arguments are based on the emergence of a strong middle class, rising oil revenue and strong economic growth of GCC countries, demand from Muslim and non-Muslim investors, and low penetration levels (Jaffer, 2006). This is complemented by the ethical character and financial stability of Islamic products.

**Due to the ethical aspects of Islamic finance (such as risk sharing, restriction on short selling) Islamic finance has been viewed by some as ‘more resilient’ in the face of the Global Financial Crisis of 2008/2009**

**Conclusion**

Using the conceptual framework in Exhibit 1, there is a strong argument for reforms to facilitate Islamic finance to proceed. Indeed, arguments for accommodating Islamic finance through tax reform are evident from private and institutional submissions at tax conferences and seminars (Sherry, 2010). The arguments put forward in these submissions suggest that changes to Australia’s current tax structure must be more reflective of tax equity and market and societal realities. However, none of these submissions have suggested a comprehensive approach on how best this might be achieved.

While there has been some activity in Australia in advancing Islamic finance, this is still largely in the formative stages. One notable reform has been the efforts of the Victorian government which introduced provisions to limit the imposition of double stamp duty on Islamic financing arrangements for home purchases, thereby allowing equal tax treatment with conventional financing arrangements. The Victorian stamp duty changes were in response to Islamic financial products being offered by MCCA.
However, there has been a conspicuous lack of enthusiasm by Australia’s conventional banking sector to tack into this emerging market. Some tangible support did emerge in June 2009 when the NAB bank announced its intention to offer Islamic loans (Gardner and Russell, 2009). Most recently, in February 2010 Westpac Banking Corp announced it would offer a commodity-trading facility aimed at overseas investors that operate in accordance with Islamic Law (Johnston, 2010). However, this move does not address the Islamic retail, banking, fund management and capital markets. Accordingly, there is some ground for Australia to expand the momentum of Islamic finance occurring. It is argued that the potential for Islamic finance to deliver financial benefits to Australia deserves greater attention – especially if the tax reforms provide greater tax neutrality for financial products regardless of whether they are faith based or not.

This paper has sought to explore whether tax reforms are justified to provide for facilitation of Islamic finance in Australia. The paper initially considered the meaning and principles of Islamic finance and demonstrated the potential tax anomalies that exist currently in Australia’s tax framework.

Then, to determine whether tax reforms should be pursued to address the breaches of tax neutrality, a ‘framework’ for tax reform was proposed. Through consideration of the dynamics between the inner factors of this framework (needs and urgency, and circumstances) with the drivers of reform (national interest, legal compatibility, equity and neutrality, fiscal, constitutionality, regulatory, political and social considerations) – it was argued that Australia should pursue the implementation of tax reforms to facilitate greater Islamic finance.

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Doing Good and Making Profits: A Case Study of Affordable Business Solutions

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Abstract

Research on the popular but controversial concept of the ‘bottom of the pyramid’ has focused on businesses that meet the needs of individuals at the bottom of the economic pyramid. Applying the same analysis to business organizations in the service markets, an information technology (IT) service provider identifies its market space, which consists of small businesses at the bottom of the pyramid. Limited in financial and knowledge resources, these small businesses are unable to take advantage of enterprise resource planning systems that facilitate integration of business processes. This paper presents and explains the innovative business model used by the IT service provider to successfully meet the needs of the small business market segment, while gaining the ‘fortune at the bottom of the pyramid’ for itself.

Introduction

The “bottom of the pyramid” (BOP) model has been successfully applied in product markets (Prahalad, 2005). In this paper, our goal is to examine how the BOP model fits the service markets. We introduce the innovative business model of Affordable Business Solutions (ABS), a young, mid-size business in the information technology (IT) sector, which maintains competitive advantage by servicing small businesses at the bottom of the pyramid (BOP)1.

In our analysis of ABS, we draw upon network theories, showing ABS to be a social connector, linking a network of suppliers with buyers. In addition, we illustrate how ABS assists businesses at the bottom of the pyramid to increase employment and productivity (Karnani, 2007). ABS also develops and shares those implementation strategies that maximize the operational efficiencies required to target the bottom of the pyramid businesses (Seelos and Mair, 2006). We also elucidate best practices of how companies, particularly entrepreneurs, can leverage their resources and capabilities to exploit opportunities and trends in the external environment, to earn increased economic returns for themselves and for their clients at the bottom of the pyramid. This case study extends the current research on businesses at the bottom of the pyramid, which to date has been limited (Seelos and Mair, 2006; Vachani and Smith, 2008).

Product Markets and Service Markets: The Difference

The BOP model has received much support from management scholars and practitioners; however, successful implementations of the model appear to be limited in number. Olsen
and Boxenbaum (2009) identify reasons that prevent organizations from adopting the BOP model, while Vachani and Smith (2008) suggest that much needs to be done to empower the consumers at the bottom of the pyramid to access goods and services.

Much needs to be done to empower the consumers at the bottom of the pyramid to access goods and services.

Many of the successful examples of implementation of the BOP model are drawn from product markets. For example, Hindustan Lever Limited (HLL), a leading multinational firm in India, learned its lesson from a local firm, Nirma, which challenged HLL in its detergent business by creating a new business system — a new product formulation, new manufacturing process, distribution, packaging, and pricing. HLL, in turn, altered its traditional business model, changing both the product and the cost structure, introducing the product at a lower price point (Prahalad, 2005).

Yet, different paradigms guide operations in the product and service markets. While the product markets employ a ‘create-produce-sell’ model, the service markets emphasizes the ‘hire-train-deploy’ model (Rosen, 2000). In this paper, we discuss and analyze both the challenges and the rewards of ABS, a firm in the IT service industry that focuses on the markets at the BOP.

CASE STUDY

Addressing Value-Denial

Recognizing the importance of information technology for their operations, business organizations continue to invest in IT infrastructure and management. Not only does IT help in automating and making business processes more efficient, it also supports the integration of business processes. Integration of business processes using technology, specifically enterprise resource planning (ERP) systems, has proven beneficial to organizations (Krishnan and Ramaswamy, 1998). These benefits include cost savings, more efficient utilization of resources, better information flow, faster response to customers, and redundancy reduction (Gopalkrishnan, 2005). However, ERP systems have earned the notorious reputation of being difficult to implement (Nah, Lau, and Kang, 2001). While some organizations take the solo route, many organizations bring in an IT service organization to facilitate the implementation of an ERP system. Outsourcing of various IT services, including ERP implementation, has become a well-accepted business practice today, and the last decade has seen phenomenal growth in this sector globally.

Small business organizations often do not have the resources to successfully implement and leverage complex technology like ERP systems in-house. Thus, even if they realize that integrated IT services can benefit the organization they are hesitant to embark alone on the uphill tasks of technology procurement and implementation. They are also hampered when trying to procure IT services from service providers, since the attention of the established service providers is on the large and medium-size organizations that have the resources to identify, outsource, and manage IT services. For many of these small businesses, previous unpleasant experiences with service providers stop them from considering outsourcing as an option for implementing integrated solutions.

While the brand ‘India, Inc.’ has become globally prominent in the area of IT outsourcing, the focus of many Indian service provider organizations has predominantly been on the U.S. and European markets or on large organizations in India. It cannot be denied that this focus of outsourcing providers makes sense, from a business standpoint, since many of these organizations invest considerable resources on training their personnel and earning quality
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In turn, this opens a large local market comprised of small businesses that could benefit from the efficiencies and savings offered by integrated systems. Lacking the know-how to implement these systems, they are hampered in their ability to grow in a business world that depends increasingly on technology. Of the twelve million small and medium-sized businesses in India, half use IT while only a few thousand have ERP systems implemented (Subrahmania, 2008).

Affordable Business Solutions (ABS) was founded as a commercial venture with the goal of addressing this ‘value-denial’ in the IT area for small businesses in India. The founders of ABS realized that by serving the large Indian market of small businesses that were at the ‘bottom of the pyramid’, they could create a successful and profitable business model. They knew that small businesses could also gain the same advantages from IT that large organizations currently enjoy. Hence, they founded a business and IT consulting firm in south India, catering exclusively to the small business market.

In the following section, we discuss in detail ABS’s business model and its impact on small businesses.

Company History and Description

ABS was established by Srikant Rao and Ravindra Kini in June 2004, in Bangalore, India. ABS provides business consulting, business solutions implementation, and IT outsourcing services to small businesses. Collectively the two founders bring several years of technical and managerial experience, as well as extensive network connection with the business world. Together these entrepreneurs bootstrapped the start-up without any venturecapital or angel investor funding. It remains a private firm, and its current annual revenues are approximately $2 million. It started with around ten employees, but now has close to one hundred employees.

Integration of business processes using technology, specifically enterprise resource planning (ERP) systems, has proven beneficial to organizations.

From the onset, ABS’s founders laid out very specific plans for their organization. Rao and Kini wanted to provide services to the small business markets that were mostly ignored by other providers. They wanted to provide these services aggregating offerings from the best brands, and leveraging packaged applications from global leaders and industry vertical solutions from local partners. The organization would focus more on functional skills than software development. By addressing industry clusters for replicability and scale, the organization yearns to build its reputation and generate favorable customer references. ABS focuses on practical solutions that provide guaranteed economic as well as relational value to its consumers.

Small Business Challenges of the Past

For small business organizations to be able to use ABS’s services, minimal investments in technology need to be made by each organization. While nearly half of the twelve million small businesses in India have invested in computer technology for business use, lack of knowledge and perceptions of unaffordability have still kept many small businesses from buying even desktop computers (Roy, 2005). This could have served as a stumbling block for the realization of ABS’ plans. Fortunately, in the same time period, attractive financing schemes such as discounted pricing for cash purchase, interest-free purchase for one year, and low interest rates, etc. were offered by computer manufacturers and resellers, with the subsidies provided by the government of India, to encourage small businesses to become computerized. While
these schemes can address concerns of financial affordability, many small businesses still have to overcome additional barriers such as inertia to organizational change, technology adoption and new learning.

ABS realized that small businesses would invest their scarce resources and take advantage of the attractive purchase options only if they were convinced of the benefits to be derived from technology. By educating small businesses on the efficiencies that could be achieved through automation as well as integration, ABS addressed a second roadblock to computerization in small businesses – the lack of knowledge.

Some of the small business organizations were using computer applications; but the costs of maintaining disparate applications, and the difficulties in manually integrating the data from these applications, were preventing them from achieving the benefits they could derive from information technology.

ABS realized that such problems made these small businesses hesitant to invest further in IT. Therefore, when ABS approached a small business firm, they completed a thorough analysis of its business processes and suggested improvements that could be implemented using technology. This initial free-of-cost analysis was intended to convince the business owners to invest in the technology required at the business location, and to avail ABS's services over the Internet.

Once the system was in place, consultants from ABS trained the users on the client-side applications. Computer users in the client firms had at least a high school degree; most had an undergraduate degree and/or had completed certificate programs in computer applications. There was no need for them to have sophisticated IT knowledge. Client organizations would not have to hire and retain information systems personnel to deal with implementation or maintenance issues, since all such issues are handled by ABS staff.

**Business Model Leveraging SaaS to Overcome Small Business Challenges**

Inspired by the concept of making a fortune by addressing the needs of those at the bottom of the pyramid, Rao and Kini crafted a business model that addresses several of the concerns of small business owners: affordability of the system, lack of resources to maintain and manage the system, potential of escalating costs due to growing requirements, fear of opportunistic behavior of vendors, and aversion to risk.

Realizing that the primary barrier to adoption of IT by these small businesses is their hesitation to invest finances up-front without guarantees of performance, ABS approaches these small organizations with a subscription-based model. ABS provides these organizations with business analytics and IT services, using Software as a Service (SaaS) delivery model where companies pay for using the software, not for owning it. The service provider is responsible for maintaining and ensuring the availability of the service. The pricing model provided additional protection to the consumers. The monthly rents the consumer paid are calculated by dividing the total cost of ownership over thirty-six months. The client can discontinue the services if tangible benefits are not visible. The account is only profitable for ABS if the subscription lasts longer than twenty-four months. As Rao explained it, “we have our skin in the game.”

Use of the SaaS model and the business analysis services provided by ABS also addresses issues related to resource availability. Since the clients can see that ABS has to maintain complementary assets, which would prevent it from acting opportunistically, ABS has been successful in gaining the trust of their clients.

Additionally, to maintain in-house IT resources and infrastructure for the client, ABS must gain expertise in the client’s business, and
provide use of quality software applications at reasonable rates. Turning over the management of these IT services to ABS through an outsourcing contract also aids the client in resource planning and allocation for growth. The monthly rent that the businesses pay is less than four percent of the total cost of outright purchase of an ERP system. For most businesses, the time from initial contact with ABS to access to a completely operational system is about three months. ABS also offers an outright purchase model for clients wishing to go that route.

For an ABS client, the initial investment includes at the minimum a powerful desktop computer with appropriate firewalls and anti-virus protection software, inverters for critical electric outlets, broadband connection, and external servers that may serve as off-site back-up to avoid loss of data and operational set-backs. A client with a larger business or multiple locations may have to make additional investments in technology. The main server, along with appropriate layered software and business application tools, are all included in the subscription from ABS.

Small business organizations often do not have the resources to successfully implement and leverage complex technology like ERP systems in-house.

ABS maintains all the data and business applications on centralized servers, strategically positioned in the geographical area they have targeted. More recently, ABS has invested in cloud computing that would eliminate the challenge of maintaining physical servers. However, ABS hires and trains personnel to maintain and manage these services, and to customize the required business application tools on behalf of the client. Its personnel have functional experience in small to medium businesses and are trained in the implementation and support of packaged applications.

Suppliers. ABS uses standard out-of-the-box technology for providing services to its clients. This is made possible by ABS’s ties with Microsoft. ABS is Microsoft’s first partner in India providing hosted enterprise resource planning (ERP) service. The partner is responsible for providing turnkey solutions, starting from initial setup and staff training, to management of the application for the company and complaint resolution. With its links to Microsoft, ABS currently offers ERP packs for basic material and financial accounting functionalities for the small business segment. Microsoft has recognized ABS’ success and named them among their preferred global partners for the region.

Corporate Rewards

The market-space that ABS targets is in a developing stage, but with significant growth opportunities. According to Roa and Kini, there are approximately 500,000 paying small to mid-sized businesses that predominantly use ‘Tally,’ the accounting software, equivalent to QuickBooks in the U.S. Based on the statistics provided by ERP vendors, only 15,000-20,000 organizations have invested in ERP so far. Assuming that even if 10% of small to mid-sized businesses will eventually migrate upwards and adopt the ERP systems, it can be estimated that the potential market for ABS over the next 3-5 years will be 50,000. Targeting a conservative market share of 10%, ABS is aiming to service 5000 businesses. Though it has an existing base of 100 businesses at present, the growth trajectory looks promising.

ABS has been in this space for almost six years now. During this period, productivity in terms of time and resource utilized for implementation has improved significantly. However, global competition is heating up with large global software companies like SAP and Oracle, and large systems integrators have entered this space. Noting ABS’s success, smaller local organizations have also started offering these types of services.
ABS has countered by introducing what they term the “reverse franchisee model” to expand geographically. In a normal franchisee model, the franchisee provides the investments and resources to set up business at a new location, while the franchisor provides the technical and managerial knowledge and collects a percentage of the revenue in return. In the reverse franchisee model, the franchisee does not need to make an upfront financial investment. The capital investment and the know-how will come from ABS, with the “reverse franchisee” being responsible for the operations and management of the activities at the new location.

Many small businesses still have to overcome additional barriers such as inertia to organizational change, technology adoption and new learning.

Ideally, Kini and Rao see the reverse franchisee concept implemented through a team of entrepreneurial-minded professionals who bring together financial management capabilities, information technology expertise, and marketing and sales skills. These teams will be trained at ABS for a minimum period of three years, giving them the chance to learn the ropes while working on different projects. Once the reverse franchisee establishes a new location, the responsibilities of the reverse franchisee include creating awareness of ABS’s services, identification of prospective customers, and providing services and support as per the ABS model, while maintaining close ties with the central office of ABS. This allows for penetration and recognition of the parent company (ABS) in new markets while providing business opportunities for entrepreneurs.

In the initial planning stages, ABS determined that it would use costs as an entry barrier and protect its market-space. Rao and Kini realized that this could only be achieved with careful and deliberate planning. ABS’s competitive advantage stems from a business model that is focused on the needs of a very specific customer group: small Indian businesses. The ABS team has functional experience in the small business sector and has been trained on implementation and support of packaged applications. By contrast, most of the competition has staff with technical backgrounds, but only limited functional experience in this sector. ABS has built a comprehensive methodology starting from an enterprise resource planning (ERP) Readiness Assessment to ERP Readiness Consulting to Rapid Implementation, and developed templates and tools that would take significant time and investment for a competitor to replicate.

Their successful client relationships are also a source of competitive advantage for ABS; it has customer references in different industry verticals. The willingness of the clients to serve as references is a result of the tangible benefits provided by ABS’s solutions and the significant growth opportunities it has produced for the clients. Outsourcing arrangements are relationship-based (Kern and Willcocks, 2000), and providing referrals is one way clients show their good will to the vendors. Further, organizations like to share their success stories.

Corporate Challenges

While Kini and Rao have realized a successful implementation of the BOP model, they still face several challenges going forward. Competition is heating up with other players in the field; for example, Salesforce.com and SAP’s Business ByDesign, which also target small to medium businesses, appear to be viable contenders in this area. ABS’s operational effectiveness and customer relationships hold it in good stead at this time. The question is, does ABS have the resources to continue on its growth track?
In the reverse franchisee model, the franchisee does not need to make an upfront financial investment. The capital investment and the know-how will come from ABS.

ABS believes that growth challenges can be met by the reverse franchisee model, with individuals trained in ABS modalities. Yet, it must be noted that the reverse franchisees build their own relationships with their clients, and provide the service based on their own interpretation and knowledge of the model defined by Kini and Rao. Would this be a good thing, and would clients find the same value as Kini and Rao want them to? Also, would ABS be able to maintain growth momentum if customers were discontent with the services?

It seems that ABS could hit a stall point (Olson and van Bever, 2008), if they are not able to find enough qualified individuals to meet the reverse franchisee standards. While their attrition rates are low, as they grow, ABS management needs to get the right individuals at a lateral level to guide the organization in different geographical regions. However, attracting individuals with the right mix of qualifications and experience would not be an easy task for a young organization like ABS. Getting a business successfully off the ground is a momentous task; yet, maintaining growth is a more difficult task. While Olson and van Bever (2008) find that only 9% of the stalls they studied could be attributed to talent bench shortfall, their data set included a mix of product and service markets. We would argue that if service markets alone were considered, this number would be higher.

Currently, ABS operations are funded by pumping back the margins into the business. ABS is fast approaching a stage where it would need an external cash infusion to attract and retain managerial talent as well as to further expand its reach geographically. ABS must attract external investment, which should not be difficult for an organization that has a proven track record and shows good promise. Such funding would go a long way in addressing some of the talent shortfall that ABS faces in the near future.

Discussion

There are four primary objectives of this paper: (1) examine how the bottom of the pyramid (BOP) paradigm fits the service market; (2) illustrate how ABS assists businesses at the bottom of the pyramid to increase employment and productivity; (3) share implementation strategies to maximize operational efficiencies required to target the bottom of the pyramid businesses; and (4) show ABS as a social connector, linking a network of suppliers and buyers in underserved markets. The ABS example shows that the BOP paradigm can be applied in service markets, while highlighting important lessons for entrepreneurs looking to create “competitive organizations that dare to care” (Delias, 2010).

In general, a connector position allows the business to enjoy informational advantages, as both buyers and suppliers alike share new knowledge, best practices, and unique processes.

Connector

In this section, we theoretically analyze ABS’s business model to ascertain that it plays a role as a connector while leveraging its resources and capabilities to avail existing external opportunities. In a network, connectors are important not only for the number of people they know, but also for the kinds of people they know (Gladwell, 2002). In this case, ABS acts as a business connector that leverages its contacts with a network of software suppliers such as Microsoft, to provide both information technology (IT) solutions and consulting services to a network of small and mid-size
companies that have not been serviced or which were previously not able to afford the technological integration and solutions. ABS, through its pay per user per month model, has made the services more affordable for buyers, since they do not have to make the heavy upfront investment. Critics like Karnani (2007) may claim that ABS is still selling to the under privileged businesses, taking advantage of their ignorance and not actually impacting the bottom of the pyramid by doing so. However, this is a misleading argument that overlooks the benefits of technology to these organizations. It can be noted that through automation, small businesses become more efficient, stable and competitive, and earn increased economic returns.

As they grow, ABS management needs to get the right individuals at a lateral level to guide the organization in different geographical regions.

Comments from clients corroborate the achievement of such benefits. Raman Fibres, a Mysore-based mid-sized organization that designs, develops and manufactures fiber-based products has used the ERP system that was developed and managed for them by ABS to reduce errors in its inventory management system; in addition, the company has been able to decrease the time and resources spent on this process. Managing Partner Ranga of N. R. Ranga Rao and Sons, incense-sticks manufacturer, comments on the benefit of being able to make timely and informed decisions by being able to “do away with the disparate applications which were giving data at different time cycles, thereby delaying the turnaround time for decision making” (Subrahmanian, 2008). On the other hand, suppliers like Microsoft benefit from increased revenues by extending existing product lines and reducing operational costs (George and Hirschheim, 2007). They are able to do so indirectly – through these connectors – without changing their business model or creating new resources or capabilities (Seelos and Mair, 2006).

In general, a connector position allows the business to enjoy informational advantages, as both buyers and suppliers alike share new knowledge, best practices, and unique processes with them in order for them to increase sales at the supplier end and provide appropriate services and consulting on the buyer end. ABS has leveraged opportunities in the business environment to create a business model that connects multiple vendors with multiple clients, integrating business processes through technology and supporting these solutions through management, training, and consulting services. Furthermore, by serving as a connector, ABS forms alliances with suppliers and buyers, making it attractive for suppliers and valuable for buyers to not behave opportunistically and, hence, to maintain long-term relationships.

**Bottom of the Pyramid Model**

In this paper, we emphasize the importance of technological innovations and solutions required by the bottom of the pyramid businesses that may help them improve their efficiencies and competitiveness. At first glance, it appears that ABS enables businesses to do just that. However, how sustainable is the growth that ABS experiences?

Karnani (2007) believes that businesses considering solutions aimed at the bottom of the pyramid should employ strategies such as providing employment, increasing government participation, increasing productivity, and creating efficient markets. In this paper, we show that ABS’s business model targets two out of the four recommendations made by Karnani - firstly, by enhancing growth of small businesses, which then increase employment, and secondly, through increasing productivity by providing complete ERP solutions. In addition, it avails the opportunity government made available for small businesses: ABS
advised potential clients to purchase computers at subsidized prices. It is the responsibility of business organizations to be innovative in leveraging the institutional environment to promote economic growth for all (Delios, 2010).

ABS bases its model on Rumelt’s theory of value denial, which states that although products or services may be desirable and feasible, they are not supplied to market. Thus, in order to assist businesses at the bottom of the pyramid to grow and to capitalize on outsourcing trends, ABS leverages its existing resources and capabilities of experience, know-how, and relationship management. This gives them a competitive advantage that may be difficult for others to duplicate.

Furthermore, in the process, ABS develops a trusting and long-term relationship with clients to earn their respect and confidence. Equally important to the clients is their vendors’ commitment to reduce opportunistic behavior. By providing a subscription-based model, ABS assures its clients that it is a truly mutually beneficial partnership structure, and that it has an equivalent stake since its revenue stream depends on its clients’ continued support, just as its clients’ productivity depends on ABS.

**Conclusion**

Researchers, economists, government and non-government agencies and industries, alike, have recently diverted much of their energy toward solving problems and providing solutions for consumers and businesses at the bottom of the pyramid. ABS is one such organization that is helping businesses at the bottom of the pyramid to improve strategic and operational efficiencies, to grow, and to earn increased economic return. Their distinct model, in turn, allows them to capitalize on their resources and capabilities for them to attain competitive advantage.

Examining the ABS example highlights the importance of collaboration among business organizations and governmental units in meeting the needs of underserved markets (Delias, 2010). Without the connections that ABS was able to establish with established software companies, it would not have been possible to provide this service. Further, the ABS founders were quick to note the benefits of the government scheme that promoted ownership of computing technology for the masses. The complementary technical and business knowledge and experience of the founders of ABS went a long way in ensuring operational effectiveness and the development of innovative initiatives like the reverse franchisee plan.

From the start, ABS had positioned itself as a business that meets the IT needs of the bottom of the pyramid. Yet, this does not exempt it from growing pains that affect all organizations. Entrepreneurs must be mindful of the talent shortfall that can affect growing firms; especially in the service industry with its ‘hire-train-deploy’ paradigm, finding the right individuals is crucial. In addition, as the business grows, it will become necessary to bring in qualified and experienced managers who have bought into the business model of the bottom of the pyramid to guide further growth.

The ABS example highlights the importance of collaboration among business organizations and governmental units in meeting the needs of underserved markets.

The reverse franchisee model is too new to make any unqualified statements about its viability. The idea shows promise, and the first center established by a reverse franchisee appears to be doing well, at the time of writing. We must note that this idea also supports the basic premise of Prahalad’s ‘bottom of the pyramid’ model: to provide opportunities where none existed before, to put ideas to work through collaboration and a desire for mutual benefit.
References


**Endnotes**

1 According to C. K. Prahalad (2005), businesses need to recognize that the large numbers of economically-challenged consumers – those at the bottom of the economic pyramid – are value-conscious consumers. Businesses need to think innovatively and address the needs of these consumers. Businesses can be profitable doing this – that is, they can get a share of the fortune at the bottom of the pyramid.

Executive Summary

Much the same as their contemporaries in Europe and Oceana, the U.S. public has expressed serious misgivings with high levels of executive compensation. However, it was not until 2010, when The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) became law, that the U.S. joined other developed economies with say-on-pay legislation. Dodd-Frank includes Section 951, which requires that shareholders of publicly traded companies be able to cast advisory “say-on-pay” proxy votes (hereafter say-on-pay votes) on executive compensation packages. As of June 30, 2011, the first proxy season where voting was required, only 1.7 percent (37) of companies in the Russell 3000 rejected the proposed compensation package. There was only one firm that “failed” say-on-pay outside the Russell 3000. Conversely, 98.3 percent of companies “passed” their say-on-pay vote.

Companies are also required to vote on how frequently shareholders should have say-on-pay votes (with four distinct choices concerning executive compensation). This decision was largely split: 54 percent were in favor of annual advisory votes and 41 percent in favor of triennial votes (with 2 percent voting for biennial frequency and 3 percent for no say-on-pay vote to be held). For those marginally performing firms, specifically those 5.7 percent of firms “passing” with less than 70 percent of shareholder votes (that is, less than 70 percent of their shareholders approved of the proposed executive compensation offering), as well as the 1.7 percent of firms that lost their say-on-pay votes in 2011, management should be particularly motivated to actively communicate, and develop dialogue, with proxy advisors, institutional investors, and other major shareholders to better understand their policy concerns and resolve any executive compensation issues before their subsequent say-on-pay vote takes place. It will be critical for these firms to have effective pay-for-performance alignment in the design and implementation of their executive compensation policies, including the elimination of any problematic pay practices.

Introduction

Over the last decade, the controversial issue of annual shareholder votes on CEO compensation heated up public policy debates, largely as a reaction to growing public concern that Chief Executive Officers (CEOs) of large, publicly-traded companies were earning too high an annual compensation package – often reflecting a disconnect between compensation and actual executive management performance, as illustrated in the Enron and WorldCom scandals. The legislative genesis of CEO and executive management binding (“required”) and non-binding (“advisory”) “say-on-pay” shareholder proxy voting requirements first occurred in Europe.

Since 2002, the United Kingdom has required publicly-traded corporations to annually hold a nonbinding, shareholder director compensation vote (Baird and Stowasser, 2002). In 2004, the Netherlands passed legislation requiring a binding shareholder vote on any change in a public corporation’s executive remuneration policy (Institutional Shareholder Service, 2007). Australia and Sweden passed legislation in 2005, the former non-binding and the latter
binding, mandating annual shareholder say-on-pay votes (Institutional Shareholder Services, 2007). In 2007, Norway followed with a non-binding, annual say-on-pay vote (Kalfen et al., 2008), with Germany enacting legislation in 2009 that also mandates an annual non-binding say-on-pay vote (Schafer and Milne, 2010). France (in 2008) and Spain (in 2009) also instituted requirements for mandatory, non-binding, say-on-pay proxy votes to be held annually by their publicly-traded companies (ISS Corporate Services, 2011).

In a similar manner to their contemporaries in Europe and Oceana, the United States public has expressed serious misgivings with high levels of executive compensation. In a July 2007 Financial Times/Harris Poll, 77 percent of Americans surveyed believed that CEOs “earn too much” (Rheannon, 2007), in line with results from another survey held that year which found that 67 percent of U.S. company board directors surveyed believed that boards were having trouble controlling the growth in CEO compensation (The Corporate Board Member and PriceWaterhouseCoopers, 2007). Beginning in 2008, two U.S. companies (AFLAC and RiskMetrics) voluntarily initiated say-on-pay votes, with Motorola following in 2009 (Council of Institutional Investors, 2011). After the 2008 global financial crisis, the U.S. government required more than 350 companies that received federal bailout assistance under the Emergency Stabilization Act of 2008, Troubled Asset Relief Program (TARP), to allow their shareholders advisory votes on executive compensation after February 2009 (Council of Institutional Investors, 2011).

However, it was not until 2010, when The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) became law that the U.S. joined other developed economies with say-on-pay legislation. Dodd-Frank includes Section 951, a provision intensely lobbied against by both the U.S. Chamber of Commerce and Business Roundtable (Jones, 2009), requiring that publicly traded company shareholders be able to cast advisory “say-on-pay” proxy votes (hereafter say-on-pay votes) on executive compensation packages. The next year, 2011, the U.S. Securities and Exchange Commission (SEC) officially adopted rules under Section 951, specifying that nonbinding say-on-pay votes are required at least once every three years and that companies are required to hold a so-called shareholder “frequency” vote at least once every six years to decide how often they would like their say-on-pay votes held.

**Shareholders use their vote to convey their dissatisfaction with executive compensation practices.**

In the U.S., state law governs the rights and duties of corporate officers and directors. Under state corporate law, the public corporation’s board of directors has a fiduciary duty to act in the furtherance of their shareholder’s financial interests at all times. However, because of the classic principal-agent problem (Jensen and Meckling, 1976), the agent (management) may exhibit undue power/influence over principals (directors – the elected representatives of shareholders) concerning executive compensation, resulting in CEOs being overpaid for their managerial performance. Bebchuk and Fried (2003) point to CEOs’ increasing levels of compensation, weak and asymmetric pay-to-performance sensitivities, and opaque disclosures as evidence of a flawed pay setting process captured by powerful CEOs.

Proponents of a mandatory binding or non-binding company say-on-pay vote argue that it strengthens the relationship between the board of directors and shareholders, helping to ensure that board members uphold their fiduciary duty and thus mitigating the principal-agent problem by structuring a set of effective management performance incentives for executive management (Jensen
and Murphy, 1990). Contrarily, other critics argue that a say-on-pay vote requirement does not effectively or comprehensively monitor executive compensation and inhibits the board’s ability to design optimal compensation packages (Cai and Walkling, 2011) – because it does not immediately impact board of directors’ decision-making – and is counter-productive because it diminishes a board’s authority to fulfill its fiduciary duty to shareholders (Tharp, 2008).

In this paper, the scholarship will focus on answering two important research questions concerning the status of corporate governance in the U.S.: 1) What were the results of the first six months of say-on-pay voting in the U.S.?, and 2) Based on these results, what does this portend for the future of this non-binding advisory vote and U.S. corporate governance in general? The subsequent analysis of these say-on-pay results will be predicated on a literature review of recent studies, as we first turn our attention to the aggregate results of the first cycle of say-on-pay voting among U.S. corporations through June 30, 2011.

The most mentioned reason for negative recommendations [was] significant “disconnects” between the company’s financial performance and its CEO’s compensation package.

First Year Say-on-Pay Shareholder Proxy Results

Equilar, Inc. (2011), a California-based executive compensation consulting company, analyzed say-on-pay voting results at the annual meetings of 2,252 companies, or 76.4 percent of those listed on the Russell 3000, up through June 30, 2011, the recognized end of the annual corporate proxy season. The question of say-on-pay frequency voting, involving four choices for shareholders, was largely split between 54 percent in favor of annual advisory votes and 41 percent in favor of triennial votes (with 2 percent voting for biennial frequency and 3 percent for no say-on-pay vote to be held) (Equilar, 2011). According to Equilar’s analysis, as of June 30, 2011, only 1.7 percent (37) of the companies in the Russell 3000 “failed” their say-on-pay vote, voting against the proposed executive compensation. (There was only one firm that “failed” say-on-pay outside the Russell 3000.) Conversely, 98.3 percent of companies “passed” their say-on-pay vote (See Exhibit I below). Equilar researchers found that 74.8 percent of companies “passed” their say-on-pay vote, with over 90 percent of their shareholders approving of the proposed executive compensation. Moreover, Equilar researchers also concluded that 129 companies (5.7 percent) passed their say-on-pay vote with between a 50 to 70 percent approval rate, while 2,085 companies (92.6 percent) passed their say-on-pay vote with greater than a 70 percent approval rate.

Exhibit I

Russell 3000 Companies
Say-on-Pay Shareholder Approval Through June 30, 2011

<table>
<thead>
<tr>
<th>Approval Range</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>90% or greater</td>
<td>2,085</td>
</tr>
<tr>
<td>70% to less than 90%</td>
<td>129</td>
</tr>
<tr>
<td>50% to less than 70%</td>
<td>37</td>
</tr>
<tr>
<td>less than 50%</td>
<td>1</td>
</tr>
</tbody>
</table>
What is surprising is that Institutional Shareholder Services (ISS), the largest advisement firm on proxy and shareholder issues in the U.S., had recommended shareholder “nay” votes on say-on-pay for 293 companies (13 percent) through June 2011 – far more than the actual 1.7 percent of company shareholders voting “nay.” According to Robert A.G. Monks, veteran corporate governance activist and founder of ISS: “Say-on-Pay is at best a diversion and at worst a deception” (Helyar, 2011). These negative results on say-on-pay votes were characterized by other commentators as a “dud” or a “bust” (Helyar, 2011).

...board of directors are not following through on their fiduciary responsibilities....

Yet according to a study by the Conference Board of the first proxy season of say-on-pay voting (through June 23, 2011), while most public companies successfully weathered their first votes during the 2011 proxy season, the vote results did reveal some weaknesses for certain companies (Barnall and Chung, 2011). James D. C. Barrall and Alice M. Chung (2011), authors of this study for the Conference Board, found that every company that failed to receive at least a majority of its say-on-pay vote had received an “against” recommendation on the vote from ISS. Moreover, even where companies passed their say-on-pay vote with 50 percent or more in spite of negative ISS recommendations, shareholder support was averaging 25 percent less than for companies that received favorable ISS recommendations. Hilburn (2011), in her say-on-pay vote analysis (for executive compensation consulting firm Frederick W. Cook & Co., Inc.) of ISS data for the Russell 3000 through June 30, 2011, came to a similar conclusion as did Barrall and Chung (2011), noting that when the ISS recommended against shareholder approval, the average passing vote was 21 percentage points below companies that were recommended for approval (i.e., 73 percent vs. 94 percent). 6

Barrall and Chung (2011) found that the most mentioned reason for negative recommendations by ISS was company “pay-for-performance” voting policies and significant “disconnects” between the company’s financial performance and its CEO’s compensation package. Hilburn (2011) found the following contentious issues identified for the companies failing say-on-pay votes (with one or more applicable for each company):

- multiple years of below total shareholder return and higher CEO pay;
- unresponsiveness to previously identified compensation issues, including majority withhold votes for compensation committee members;
- excessively high CEO pay or special retention awards;
- excessively high year-over-year increase in CEO pay; and
- egregious problematic pay practices.

Furthermore, Hilburn (2011) notes that five of the 37 Russell 3000 companies failing their say-on-pay vote are currently the subject of derivative suits filed on behalf of shareholders, each naming the compensation committee, the committee’s compensation consultant, and various other executive officers. According to Hilburn (2011), legal experts believe that all companies with failed say-on-pay votes will eventually be sued; however, the legal consensus is that all of the suits will be dismissed without merit.

Companies and institutional investors [should] carefully monitor the analyses and recommendations they receive from their proxy advisory firms.

In a “white paper” prepared by Farient Associates for the Council of Institutional Investors (CII) (2011), the 37 “failed” say-on-
“pay” votes from annual meetings taking place between January 1 and July 1, 2011 were analyzed to help both investors and companies in structuring future voting policies. Farient Associates interviewed 19 members of CII, including public employee pension funds, mutual funds and union pension funds, as well as the two largest proxy advisory firms, ISS and Glass Lewis & Co., as well as proxy solicitation firm Morrow & Co. LLC, to ascertain, among other things, the factors that motivated investors to vote against executive compensation programs at companies with failed say-on-pay votes (Council of Institutional Investors, 2011).

The most common reasons cited for investors voting against say-on-pay compensation programs include:

- disconnect between performance and proposed compensation package (92 percent);
- poor pay practices (57 percent), including excessive long-term incentives and severance paid out, as well as a lack of compensation “clawbacks”;
- poor disclosure by the company (35 percent); and
- an overall lack of pay reasonableness (16 percent) (Council of Institutional Investors, 2011).

**Proxy Advisory Industry Criticisms**

Nevertheless, there are substantive reasons why the percentage of “nay” votes was much lower than ISS had recommended. The Washington, D.C.-based Center on Executive Compensation (“Center”), an offshoot of the HR Policy Association and a lobbying group on human resource issues for 300 of the largest U.S. corporations, sent out a letter on February 7, 2011, to the CEOs of the top 100 institutional investors recommending that they redouble their efforts to closely monitor the proxy advisory firms that they retain: ISS, Glass Lewis (the No. 2 proxy advisory firm), and others (Center on Executive Compensation, 2011b). Commented Charles G. Tharp, executive vice president for policy of the Center:

As institutional investors know, they have a fiduciary duty to monitor corporate events and vote their proxies in the best interests of their clients. Conflicts in proxy advocacy firm operations and inaccuracies in their recommendations could lead to erroneous voting decisions that may adversely impact companies and ultimately investors [Center on Executive Compensation, 2011b].

Moreover, this letter reflects the recommendations and conclusions found in a January 2011 white paper (A Call for Change in the Proxy Advisory Industry Status Quo) issued by the Center that accused ISS of publishing errors, holding excessive power, and beset by conflicts of interests because it both consults with some companies on corporate governance issues and recommends proxy voting advice to them (Center on Executive Compensation, 2011a). To address these concerns, the Center’s white paper recommends: that companies and institutional investors carefully monitor the analyses and recommendations they receive from their proxy advisory firms to ensure that they reflect a close link between executive compensation and company performance; require that their proxy advisory firm eliminate the worst conflicts of interest; require their proxy advisory firm to disclose any disagreements by companies regarding the characterization of a pay or governance matter in their client reports; and that there be increased SEC regulatory oversight of the proxy advisory industry.

... the critical role played by a negative proxy advisory firm...could jeopardize a future positive shareholder vote outcome.

Other critics fault ISS for employing a flawed executive compensation methodology,
whereby the ISS analysis fails to take into account the value of actual compensation earned and realized from long-term grants (based on accounting rules applied at the time of the grant), as these grants, particularly stock options and performance shares, have not delivered any real value nor will they unless some board-specified performance goal is met by the CEO. Institutional investors, such as mutual funds, own 70 percent of U.S. equities and are often contracted by major corporations to manage employee 401(k) plans. This business arrangement makes institutional investors loathe to dissent against management unless there is strong evidence of a major disconnect between management performance and CEO compensation packages (Helyar, 2011). Apparently this Center letter influenced the natural disinclination by many institutional investors to vote “nay” on say-on-pay shareholder proxy proposals who received a negative recommendation from ISS, including Pfizer (57 percent shareholder approval), ExxonMobil (67 percent shareholder approval), and JP Morgan Chase (73 percent shareholder approval) (Helyar, 2011).

CEO Compensation and Turnover Trends

Another factor in the 2011 say-on-pay shareholder voting outcome is that, contrary to what the media and many corporate governance activists say about CEOs being paid ever higher compensation year-after-year without regard for their performance, and that boards of directors are not following through on their fiduciary responsibilities, there is recent research that CEO pay in the U.S. has decreased over the last decade, are being paid for actual managerial performance, and that boards are aggressively removing CEOs who do not meet performance metrics. Kaplan and Rauh (2010) found that in 2000, Standard & Poor’s 500 boards paid their CEOs an annual average of almost $17 million (in inflation-adjusted dollars) in compensation, including salary, bonus, restricted stock, and the expected value of options. In 2009, the average CEO compensation was less than $8.5 million, a decline of approximately 50 percent from 2000. Data such as this is rarely reported by the media or corporate governance critics (Kaplan and Rauh, 2010).

Kaplan and Rauh (2010) also argue that it is important to focus on realized pay rather than the amount of compensation the board estimates it is offering that executive. Realized pay differs from estimated pay by substituting the value of exercised options for the estimated value of options granted, and is a better measure of what the CEO actually receives in compensation annually. Furthermore, Jenter and Lewellen (2010), in their recent study of CEO performance and turnover, found that 17 percent of chief executives with strong stock performance (in the top quintile) were removed from their position over a five-year period, while 59 percent of those with weak stock performance (in the bottom quintile) were leaving office over that same five-year period – a stunning 42 percent differential in board decision-making accountability (Jenter and Lewellen, 2010). Recent say-on-pay voting results lend support to the position that shareholders overwhelmingly agree with corporate board assessments and employment decisions.

Discussion and Recommendations

It would be premature to presume that the 2011 proxy season result for say-on-pay votes is the final word on this issue. For instance, there is indication that institutional investors will increase their involvement in say-on-pay voting during the 2012 proxy season. Even for companies that “won” their say-on-pay vote in 2011 with greater than 70 percent approval results, the critical role played by a negative proxy advisory firm recommendation (based on a disconnection between executive compensation and total shareholder return over a year or two) could jeopardize a future positive shareholder vote outcome.
Moreover, the SEC intends to issue final administrative rules on Sections 953, 954 and 955 by the end of 2012. Section 953 concerns compensation matters including pay-for-performance policies and the ratio between the CEO’s total compensation and the median total compensation for all other company employees. Section 954, the claw-back provision, prohibits securities exchanges from listing publicly-traded companies that have not developed, implemented and disclosed a policy concerning the recoupment of incentive-based compensation when that compensation was based on performance criteria of reported financial statements and the company restates its financial statements due to material noncompliance with financial reporting requirements. Section 955 mandates further disclosures concerning whether directors and employees are permitted to hedge any decrease in the market value of the company’s stock.

This additional SEC disclosure requirement will undoubtedly create increased pressure on marginally performing firms, specifically those 5.7 percent of firms passing with less than 70 percent of shareholder votes, as well as the 1.7 percent of firms that lost their say-on-pay votes. These firms should be particularly motivated to actively communicate, and develop dialogue, with proxy advisors, institutional investors, and other major shareholders to better understand their policy concerns and resolve any executive compensation issues before their subsequent say-on-pay vote takes place. It will be critical for these firms to have effective pay-for-performance alignment in the design and implementation of their executive compensation policies, including the elimination of any problematic pay practices. Nevertheless, this first year result of a 98.3 percent say-on-pay voting approval rate reflects the overall satisfaction that investors have with the compensation packages that their boards of directors recommended for company CEOs. The silver lining from requiring this advisory say-on-pay proxy vote may be found in the fact that some companies did change outstanding agreements or made commitments to prospectively change their compensation policies to reverse negative proxy adviser recommendations before their 2011 say-on-pay vote was scheduled. Most CEOs can breathe a sigh of momentary relief – at least until next year’s proxy season arrives.

Endnotes
1 Researchers have recently begun to evaluate the British say-on-pay experience, with mixed empirical results. Alissa (2009) found evidence that shareholders use their vote to convey their dissatisfaction with executive compensation practices. Furthermore, UK boards respond to shareholder’s dissatisfaction by either reducing excess CEO compensation for firms whose CEOs have above average excess compensation, or by forcing the CEO out of office. Conyon and Sadler (2010) found that:

- first, less than 10 percent of shareholders abstain or vote against CEO compensation;
- second, investors are more likely to vote for a mandated Directors’ Remuneration Report than non-pay resolutions;
- third, shareholders are more likely to vote against general executive pay resolutions compared to non-pay resolutions;
- fourth, firms with higher CEO pay attract greater voting dissent; and
- fifth, there is little evidence that CEO pay is lower in firms that previously experienced high levels of shareholder dissent.

Conyon and Sadler (2010) also found limited evidence that, on average, say-on-pay materially alters the subsequent level and design of CEO compensation. Ferri and Maber (2011), after examining data on nonbinding say-on-pay voting in the UK, found that it results in greater penalties for CEO poor performance. In particular, they found that firms experiencing high-voting dissent respond by removing controversial provisions that investors criticize as “rewards for failure”, such as large severance payouts. Furthermore, Ferri and Maber (2011) found that the threat of voting dissent appears to have the effect that, when firms remove controversial provisions before the vote takes place, they experience low shareholder dissent.

2 Clarkson, Walker and Nicholls (2011) recently published a paper on the effect of increased shareholder oversight and disclosure regarding
executive compensation in Australia over the years 2001-2009. Over the period of the study, the researchers found a general strengthening of the pay-performance relationship, with the increased sensitivity of reported CEO compensation to firm performance being primarily related to enhanced compensation disclosure and the non-binding shareholder vote (the average “no” vote on CEO compensation rising from 5.4 percent in 2005, the first year of the vote, to 11.4 percent in 2009).

3 It is noted that approximately 70 U.S. companies adopted say-on-pay shareholder voting voluntarily in recent times (The Wharton School, 2011).

4 On February 24, 2009, the U.S. Securities and Exchange Commission (SEC) clarified that the non-binding say-on-pay provision for all TARP recipient firms became effective on February 17, 2009, and applies to preliminary or definitive proxy statements filed with the SEC after February 17, 2009 (U.S. Securities and Exchange Commission, 2009). According to Barrall and Chung (2011), none of the approximately 240 financial institutions required to hold say-on-pay votes under TARP in 2009 or in 2010 received less than majority shareholder support.

5 The position of the Business Roundtable, the National Association of Manufacturers and the U.S. Chamber of Congress is that publicly-traded companies have the authority to institute voluntary, advisory say-on-pay shareholder votes without passing federal legislation. Furthermore, the Republican Party’s position has been that small groups of activist shareholders could use the say-on-pay process to advance political agendas and create a distraction for boards of directors. Organizations supporting say-on-pay legislation include the Service Employees International Union and the Social Investment Forum. Congressional Democrat supporters in Congress, including former Representative Barney Frank (MA), Senator (and later President) Barack Obama (IL), Senator Christopher Dodd (CT) and Senator Charles Schumer (NY), espoused giving shareholders the ability to directly approve or disapprove executive compensation packages, so as to keep executive compensation in check, and have boards of directors of publicly-traded corporations be more thoughtful in approving executive compensation.

6 According to research undertaken by Morgan, Poulsen and Wolf (2006), who were studying management-sponsored compensation proposals covering the period between 1992 and 2003, these researchers found that an unfavorable recommendation on a proposal by a proxy advisory firm can reduce shareholder support by as much as 20 percent.

7 In a BDO U.S.A LLP (2011) study on Dodd-Frank say-on-pay rules, company researchers found that 78 percent of board members surveyed do not believe Dodd-Frank’s compensation disclosure rules help them better manage the compensation of their firm’s executives. Furthermore, the researchers argue that pay practices advocated by proxy advisory groups often emphasize immediate pay-for-performance tie-ins, at the expense of other strategic investments and strategy shifts, and they do not manifest in immediate measurable returns. Nonetheless, 76 percent of directors do not find the non-binding nature of the say-on-pay votes diminish board effectiveness, with directors serving on their boards’ audit (85 percent) and compensation committees (79 percent) more inclined to support this position.

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Overinvestment in Residential Real Estate: An Analysis of the Impact Across Levels of Economic Diversification

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Executive Summary

This paper examines county-level data within metropolitan statistical areas in two east coast states, to explain variation in the magnitude of the boom and bust in residential real estate from 2001 to 2010. Evidence of past housing cycles demonstrates that real estate is not immune to volatility or devaluation. It responds to changes in supply and demand. Wheaton’s (2005) analysis of ski resort real estate prices in Loon Mountain, New Hampshire, suggests that resort areas are especially vulnerable to boom and bust episodes, particularly due to additional demand forces from secondary or recreational home ownership.

An important result from the present study concerns the effect in resort destination areas and areas where income growth was less than average over the decade. The findings are consistent with those from Wheaton (2005), and show that building activity and home prices are more elastic in areas considered to be vacation-type destinations as compared with activity and price changes in non-vacation destination counties. These findings have implications for policy makers, and suggest the need for reconsideration of decades of federal housing policies that were, among other things, intended to stabilize the workforce in the U.S.

Introduction

Federal incentives have been a growing factor in the residential real estate market for decades. These incentives, combined with historically low interest rates, created an unprecedented expansion in housing construction in the last decade, and by the peak of the expansion in 2006, the annual volume of new home sales was 156% greater than the level in 1992. The potential for overinvestment was rarely viewed as a serious risk for the long list of stakeholders including homeowners, builders, investors, real estate and finance professionals, government officials and others. Yet, by 2010 the annual volume of new home sales stood 73% below the 2006 peak.

There are many reasons to be concerned about instability in real estate and construction. These sectors combined averaged 16 percent of the value-added to GDP from 1998 to 2009. This does not include direct banking services supporting real estate and construction transactions, nor does it consider the key role mortgage lending played in the overall

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financial sector and the many consumer and business activities that benefitted from bank credit. Another concern is the impact on worker mobility when home prices drop significantly below their mortgage balance. The decreased liquidity in residential real estate has a dragging effect on the recovery in employment.

Decreased liquidity in residential real estate has a dragging effect on the recovery in employment.

Casual observation of various markets in North and South Carolina suggests the magnitude of the latest housing cycle varied considerably across different locations within regions. These states comprise a mix of coastal, mountain, and major metropolitan regions, with varying degrees of government and private sector activity. Certain cities in the major resort areas of these states appear to have suffered much greater in the last housing recession. Researchers have noted this tendency in past studies. Gallin (2006) reports that many large coastal cities suffered dramatic price swings in the 1980s and 1990s. Wheaton (2005) tries to explain why real prices actually fell over a 25-year period in the resort area of Loon Mountain, Hew Hampshire.

These studies and others highlight the importance of the supply response to changes in the lending environment, inflation expectations, and other expected economic outcomes. In the latest building and real estate boom, the opportunity for small and/or novice investors to join the supply side of the market became widely recognizable, with some television networks devoting entire shows to “flipping” properties. This phenomenon may have been greater in areas where the cost of undertaking a new entrepreneurial risk might have been lower or the rewards greater.

Smaller resort communities in the Southeast are one type of area where the economic conditions might have induced such undertakings. Resort communities are typically less economically diverse, with fewer corporate employment opportunities and higher rates of self-employment. These are also areas where conspicuous consumption may play an important motivating role in real estate transactions, yielding an increasing number of transactions and a higher rate of short-term price appreciation (Turnbull, Dombrow, and Sirmans, 2006).

This type of real estate investing can affect the demand and supply side of the market simultaneously. In an environment of rapidly rising home prices and loose lending requirements secured by subsidized deposit insurance, individuals were able to leverage a small amount of cash into multiple investment properties, often four or five homes that were purchased to sell for a higher price within a few months. As this type of activity increased, outside development firms, banks, and other supply-side participants could easily have mistaken this surge in transactions as an indication of a growing area with greater demand for housing. The forces of supply and demand became tangled.

The resulting collapse in housing suggests that the actual level of sustainable demand, as determined by real income constraints, was much less than perceived. Was this collapse greater in resort regions where low barriers to short-term profits may have played a greater role, or is the widely-regarded price-income ratio a better indicator of where home prices are likely to fall the furthest from the peak?

This article is one of the first to empirically examine these alternative explanations for the extent of the collapse in home prices and the drop in construction activity. This study is motivated by the recognition that new housing supply is very elastic in the short-run. Given that supply and demand subsidies in the housing market reduce barriers to
investment and home ownership, are the long-run outcomes consistent with the policies’ intentions? Do areas with less income growth suffer more after experiencing housing booms?

The discussion is organized as follows: the next section summarizes government housing policies and cyclical instability in the U.S. housing market. The empirical analysis and results are discussed in the third section, and the fourth section concludes.

**Government Housing Policies and Cyclical Instability**

Cyclical instability in real estate and construction has ramifications for the overall U.S. economy, and this instability is not new. Grebler and Burns (1982) identify six major private, residential construction cycles from 1950 to 1973. This, of course, does not include the housing cycle from the late-1970s to the early 1980s and the cycle from the mid-1980s to the early 1990s. Housing began another run in the late-1990s and it is still not certain when the declining phase of this latest cycle will cease (Gallin, 2006).

Government sponsorship of mortgages, tax laws favoring real estate, and accommodating liquidity measures by the Federal Reserve have played a major role in the U.S. housing market for decades. As a consequence, the housing market has changed dramatically since the Great Depression. In 1934, Congress created the Federal Housing Administration to provide mortgage insurance in an effort to increase the rate of home ownership. According to the Department of Housing and Urban Development, before the FHA mortgage loans were generally limited to fifty percent of the value of the house and a term of five years or less, with a balloon payment at the end of the period. The rate of home ownership was below forty percent. By the 1960’s, the rate of home ownership had increased to sixty-five percent, and it stands near this level as of this writing.

In 1938, the FHA chartered Fannie Mae in order to help support Congress’s expressed goal to expand home ownership. Fannie Mae purchases, holds, and sells government-supported mortgages and is particularly active in the secondary mortgage market, or mortgage-backed securities. In 1970, Congress chartered Freddie Mac to add “liquidity, stability, and affordability” to the housing market. It also participates in the secondary mortgage market.

In addition to these government and government-sponsored entities, there are numerous regulations, tax laws and incentives that favor real estate over other investments in an effort to accommodate Congress’s decades-old mission of supporting home ownership. The Community Reinvestment Act of 1977 requires banks to hold a portion of its business portfolio in lower-income population segments, and banks undergo periodic review to ensure that their portfolios meet these requirements.

The government also provides incentives to individuals, including mortgage interest and insurance deductibility, property insurance premium deductibility, and favorable treatment of capital gains from the sale of primary and secondary homes. Finally, the Federal Reserve accommodates housing policies’ aims through the use of ‘easy money’ policy, particularly expanding the monetary base, helping to provide a market for U.S. treasury bonds, and helping to ensure low interest rates to induce borrowing.

**Resort communities [usually have] fewer corporate employment opportunities and higher rates of self-employment.**

Given the documented cyclical nature of the housing market, all of these measures notwithstanding, the effect on individual households and firms should be considered. Homeowners who took advantage of low and
no-equity mortgages and low introductory but variable rate mortgages generally had trouble paying their mortgages when interest rates rose, home prices fell, and the housing market receded. As prices fall, foreclosures increase and the stream of payments on mortgage-backed securities begins to dry up, causing the market value of these securities to fall. As losses on these securities mount, companies that insured these investments incur tremendous losses. Arguably, the extent of all of this activity was greater in the current housing cycle than in any previous period, as Exhibit 1 suggests.

Exhibit 1
U.S. Single Family Permits 1959-2010

Empirical Methodology and Results

This paper uses metropolitan statistical area (MSA) and county level price, and permits data from two east coast states to analyze the relationship between location and demographic factors and prices over the 10-year period from 2001 to 2010. The data comprise sixty-one counties belonging to fifteen separate MSAs in North Carolina and ten MSAs in South Carolina. The modeling approach is a cross-section analysis of the changes in the variables over the 10-year period across the counties. See Exhibit 2 for variable definitions and sources, and Exhibit 3 for summary statistics.

<table>
<thead>
<tr>
<th>Variable Name</th>
<th>Variable Definition</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitclimb</td>
<td>Percent change in annual single family permit activity from 2001 to the peak for the county</td>
<td>HUD State of the Cities Data System, and calculation by author</td>
</tr>
<tr>
<td>Permitdrop</td>
<td>Percent change in annual single family permit activity from peak through 2010 for the county</td>
<td>HUD State of the Cities Data System, and calculation by author</td>
</tr>
<tr>
<td>Pop00</td>
<td>2000 county population</td>
<td>U.S. Census</td>
</tr>
<tr>
<td>Pop10</td>
<td>2010 county population</td>
<td>U.S. Census</td>
</tr>
<tr>
<td>Popchange</td>
<td>Percent change in county population over the decade</td>
<td>Calculation by author</td>
</tr>
<tr>
<td>Density00</td>
<td>County population in 2000 divided by county land area</td>
<td>U.S. Census, and calculation by author</td>
</tr>
<tr>
<td>Medhhinc99</td>
<td>County nominal median household income in 1999</td>
<td>U.S. Census</td>
</tr>
<tr>
<td>Medhhinc09</td>
<td>County nominal median household income in 2009</td>
<td>U.S. Census</td>
</tr>
<tr>
<td>Incomechange</td>
<td>Percent change in county median household income over the decade</td>
<td>Calculation by author</td>
</tr>
<tr>
<td>Ownoccshare</td>
<td>Owner-occupied share of total occupied housing in county</td>
<td>U.S. Census, and calculation by author</td>
</tr>
<tr>
<td>Vacation</td>
<td>Binary indicator for whether or not county is a major resort destination</td>
<td>Compiled by author</td>
</tr>
<tr>
<td>Priceclimb</td>
<td>Percent change in price index from 2001 to the peak for the county</td>
<td>Freddie Mac House Price Index, and calculation by author</td>
</tr>
<tr>
<td>Pricedrop</td>
<td>Percent change in price index from peak through 2010 for the county</td>
<td>Freddie Mac House Price Index, and calculation by author</td>
</tr>
</tbody>
</table>

...as median home prices increase further from median income, the local housing market may become unstable.
Exhibit 3.
Summary Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitclimb</td>
<td>61</td>
<td>60.31%</td>
<td>64.72</td>
<td>0</td>
<td>362.39%</td>
</tr>
<tr>
<td>Permitdrop</td>
<td>61</td>
<td>68.83%</td>
<td>15.13</td>
<td>0</td>
<td>86.91%</td>
</tr>
<tr>
<td>Pop00</td>
<td>61</td>
<td>142,695</td>
<td>133,207</td>
<td>15,185</td>
<td>695,454</td>
</tr>
<tr>
<td>Pop10</td>
<td>61</td>
<td>171,975</td>
<td>176,716</td>
<td>14,412</td>
<td>928,585</td>
</tr>
<tr>
<td>Popchange</td>
<td>61</td>
<td>16.96%</td>
<td>15.00</td>
<td>-5.09%</td>
<td>63.32%</td>
</tr>
<tr>
<td>Density00</td>
<td>61</td>
<td>254.82</td>
<td>235.08</td>
<td>34.16</td>
<td>1318.65</td>
</tr>
<tr>
<td>Medhhinc99</td>
<td>61</td>
<td>$38,564</td>
<td>$29,849</td>
<td>$54,988</td>
<td></td>
</tr>
<tr>
<td>Medhhinc09</td>
<td>61</td>
<td>$43,991</td>
<td>$32,500</td>
<td>$63,770</td>
<td></td>
</tr>
<tr>
<td>Incomechange</td>
<td>61</td>
<td>13.95%</td>
<td>6.98</td>
<td>-.7%</td>
<td>33.43%</td>
</tr>
<tr>
<td>Ownocchshare</td>
<td>61</td>
<td>72.98%</td>
<td>6.91</td>
<td>54.26%</td>
<td>84.35%</td>
</tr>
<tr>
<td>Vacation</td>
<td>61</td>
<td>NA</td>
<td>NA</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Priceclimb</td>
<td>61</td>
<td>32.10%</td>
<td>18.95</td>
<td>8.19%</td>
<td>95.84%</td>
</tr>
<tr>
<td>Pricedrop</td>
<td>61</td>
<td>9.12%</td>
<td>5.01</td>
<td>1.39%</td>
<td>25.23%</td>
</tr>
</tbody>
</table>

decade in the county. Density00 measures the population density in persons per square mile based on the county’s population in 2000 and the total land area.

Medhhinc99 and Medhhinc09 are the median household income for the county in 1999 and 2009 respectively. These measures attempt to control for ability to pay, in correspondence with recommended price-income ratios. Generally, as median home prices increase further from median income, the local housing market may become unstable.

The variable Incomechange measures the percentage change in median household income over the decade for the county. The greater the increase in income, the more likely the local economy can support increasing home prices.

The variable Ownocchshare measures the share of total housing in a county that is owner-occupied. This is one measure of the effect of housing policies designed to increase the rate of home ownership in the U.S. The intent of the variable is to measure the impact of primary residential home ownership demand on home prices and building activity.

Do areas with less income growth suffer more after experiencing housing booms?

The variable Vacation is a dummy variable that indicates whether or not the county is in a resort destination. A resort destination can include beaches, lakes, large rivers, or popular mountain destinations. This variable attempts to capture any effect of secondary or recreational home ownership demand on prices and building activity.

Results

Exhibit 4 summarizes results from the regressions in which the dependent variable is Priceclimb. In each of these regressions, the variable Vacation is positive and significant.
It appears that, controlling for other characteristics of demand, vacation areas experienced above average increases in price from 2001 to the peak of the housing boom.

The variable Incomechange was also positive and significant as expected. Two other variables are significant in the models. Medhhinc99 is negative and significant, indicating that price climbs were greater as a percentage in lower income regions, which is also consistent with the hypothesis that areas with low barriers to entry and low opportunity costs for entrepreneurs experienced the greatest increases in activity and prices.

In the last model, the variable Permitclimb was included as a robustness check. This variable is positive and significant as expected, and the remaining variables are robust to the addition of this variable.

The Ownoccshare variable was insignificant in all models. Perhaps one explanation is the small change in this variable over the 10-year period relative to the large change in the dependent variable. Finally, the variables Popchange, Density00, and Pop00 were not significant in any of the models.

Exhibit 4.
Regression results for dependent variable = Priceclimb

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Model 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incomechange</td>
<td>1.19 (3.54)***</td>
<td>1.19 (3.50)***</td>
<td>1.26 (3.21)***</td>
<td>1.37 (4.04)***</td>
<td>1.30 (3.81)***</td>
</tr>
<tr>
<td>Popchange</td>
<td>-.006 (-0.05)</td>
<td>-.005 (-0.04)</td>
<td>-.028 (-0.19)</td>
<td>.323 (1.54)</td>
<td>.122 (0.64)</td>
</tr>
<tr>
<td>Density00</td>
<td>.002 (0.11)</td>
<td>.005 (0.20)</td>
<td>.020 (0.93)</td>
<td>.025 (1.20)</td>
<td></td>
</tr>
<tr>
<td>Pop00</td>
<td>-.00005 (-0.40)</td>
<td>-.00009 (0.78)</td>
<td>-.00015 (-1.37)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medhhinc99</td>
<td>-.002 (2.87)***</td>
<td>-.002 (2.23)**</td>
<td>-.002 (2.87)***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permitclimb</td>
<td>.86 (3.07)***</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>9.06 (2.23)**</td>
<td>8.81 (2.00)**</td>
<td>7.67 (1.36)</td>
<td>77.42 (3.12)***</td>
<td>51.5 (2.38)**</td>
</tr>
<tr>
<td>N=</td>
<td>61</td>
<td>61</td>
<td>61</td>
<td>61</td>
<td>61</td>
</tr>
<tr>
<td>R-square</td>
<td>.53</td>
<td>.53</td>
<td>.53</td>
<td>.61</td>
<td>.67</td>
</tr>
</tbody>
</table>

T-statistics in parentheses, calculated using White’s robust standard errors.
* **, *** represents significance at the 1%, 5%, and 10% level respectively.
State dummy included in all regressions (NC = 1).

Exhibit 5 summarizes results from the regressions in which the dependent variable is Pricedrop. In these models, the variable Vacation is not robust to the addition of variables across model specifications. Notably, the addition of Incomechange seems to affect the strength of the Vacation variable. Incomechange is negative and significant at the 1% level in three of the four model specifications. As the
percentage growth in income is larger over the decade, the drop in prices becomes less severe. This is a very intuitive result, consistent with the price-income ratio constraint for affordability and the stability of demand. It is possible that vacation regions are highly correlated with this variable.

As expected, the Priceclimb variable is also positive and significant. Counties with the largest price increases tended to have the greatest price drops. The variable Permitdrop is also positive and significant, as expected. Once again the Ownocc2000 variable is insignificant in all model specifications, and the remaining demographic variables are insignificant as well.

Exhibit 5.
Regression results for dependent variable = Pricedrop

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vacation</td>
<td>5.34 (3.75)***</td>
<td>1.81 (1.77)*</td>
<td>1.73 (1.67)*</td>
<td>1.377 (1.41)</td>
</tr>
<tr>
<td>Ownocc2000</td>
<td>.168 (1.47)</td>
<td>.139 (1.30)</td>
<td>.151 (1.38)</td>
<td>.056 (0.67)</td>
</tr>
<tr>
<td>Incomechange</td>
<td>-.059 (-0.61)</td>
<td>-.305 (-3.15)***</td>
<td>-2.97 (-3.13)***</td>
<td>-.227 (-2.99)***</td>
</tr>
<tr>
<td>Popchange</td>
<td>.129 (1.51)</td>
<td>.062 (1.08)</td>
<td>.044 (0.76)</td>
<td>.050 (1.25)</td>
</tr>
<tr>
<td>Density00</td>
<td>.002 (0.36)</td>
<td>-.001 (-0.31)</td>
<td>-.0004 (0.09)</td>
<td>-.002 (-0.73)</td>
</tr>
<tr>
<td>Pop00</td>
<td>3.17e-06 (0.33)</td>
<td>7.83e-09 (0.00)</td>
<td>2.26e-06 (0.40)</td>
<td>2.26e-06 (0.40)</td>
</tr>
<tr>
<td>Medhhinc99</td>
<td>-.0004 (-1.51)</td>
<td>1.31e-06 (0.20)</td>
<td>.00003 (0.17)</td>
<td>.00006 (-0.47)</td>
</tr>
<tr>
<td>Priceclimb</td>
<td>.190 (4.81)***</td>
<td>.173 (4.37)***</td>
<td>.163 (4.76)***</td>
<td>.163 (4.76)***</td>
</tr>
<tr>
<td>Permitclimb</td>
<td>.011 (1.30)</td>
<td>.014 (1.64)</td>
<td>.014 (1.64)</td>
<td>.014 (1.64)</td>
</tr>
<tr>
<td>Permitdrop</td>
<td></td>
<td>.109 (4.13)***</td>
<td>.109 (4.13)***</td>
<td>.109 (4.13)***</td>
</tr>
<tr>
<td>Constant</td>
<td>8.876 (0.68)</td>
<td>-3.892 (-0.33)</td>
<td>-6.644 (-0.58)</td>
<td>-4.207 (-0.58)</td>
</tr>
<tr>
<td>N=</td>
<td>61</td>
<td>61</td>
<td>61</td>
<td>61</td>
</tr>
<tr>
<td>R-square</td>
<td>.44</td>
<td>.61</td>
<td>.66</td>
<td>.73</td>
</tr>
</tbody>
</table>

T-statistics in parentheses, calculated using White’s robust standard errors.
*, **, *** represents significance at the 1%, 5%, and 10% level respectively.
State dummy included in all regressions (NC = 1).

Conclusion

This study examined the magnitude of the housing cycles across sixty-one counties in the MSA’s of North and South Carolina. From the period 2001 through 2010, many counties experienced extreme swings in prices and building activity. Past research has indicated that resort areas are especially vulnerable to boom and bust episodes, particularly because of the additional demand forces from secondary or recreational home demand. The results of this study are consistent with other studies.
An important finding unique to this study is the identification of a more fundamental factor underlying these episodes of boom and bust. Resort regions tend to be areas of less economic diversity and stagnant income growth. Housing market booms may affect these areas more, due to the resulting lower opportunity costs for potential small investors and entrepreneurs. Land in outlying areas of resort communities is often underutilized and employment opportunities are scarcer, creating plenty of supply for new homes and an eager workforce for their construction. Unfortunately, these booms are temporary, and the supply-demand imbalance adjusts itself through a downward price adjustment and lower demand for construction labor, capital, and entrepreneurial ability.

This latest national housing cycle presents many opportunities for future research. Extending the geographical scope would provide more robust insight into these questions. Other measures of home prices in future analysis might help policymakers better understand the sources of significant disruptions in related financial markets.

References


The Values of the Determinants and Tests of Stability of the Money Demand Function of the United States

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Executive Summary

Using multivariate cointegration methodology, this paper examines the long-run stability of the U.S. money demand function using both nominal and real M1 and M2 monetary aggregates. The estimated results, based on the Johansen cointegration technique, found evidence that the U.S. M1 and M2 demand functions, nominal or real, have long-run stability. The magnitudes of the estimated parameters are different for different specifications of the models. The estimated real income elasticity and interest rate elasticity, over the specifications of the money demand functions, are more sensitive to the choice of the interest rate and less sensitive to the scale variable. The implication of this stability is that there is at least one common factor which influences money supply, real income and interest rates. This finding comes as no surprise, given the coordinated monetary policy of the U.S. Federal Reserve to control output and avoid inflation.

The empirical results of this study, with respect to M1 money demand, are in contrast with the empirical evidence presented in some of the earlier studies.

Introduction

Tests on stability of the demand for money function conducted in the studies prior to the mid-1980s were controversial. Recent developments in cointegration technique provided a more precise way to reexamine the stability issue. The objective of this paper is to apply the cointegration technique, proposed by Soren Johansen (1988), to test the stability of the U.S. money demand function.

There are several advantages in applying the cointegration technique to study the long-run behavior of money demand. It allows us to investigate independently the long-run demand for money without the need for deciding which of the many postulates of its short-run dynamics should be explicitly explored. The error correction technique
that is complementary to cointegration methodology gives us this full flexibility to model short-run dynamics in several ways. For instance, in cointegration methodology, the debate whether to include current income or permanent income (or both) as arguments in the money demand function does not arise, because permanent income is the steady state value of the current income.

**Methodology**

For analytical purposes we start with Fisher’s equation of exchange, and use the transformed version of this identity as our money demand function for cointegration tests. Following this discussion, empirical results of the cointegration test are presented.

Fisher’s equation of exchange \(MV = Py\), in natural logs, (see Dickey et al, 1991), is:

\[
\ln M + \ln V - \ln P - \ln y = 0
\]

where \(M\) is nominal money, \(V\) is velocity, \(P\) is the price level, and \(y\) is real income (\(Q/P\), \(Q=\)Output and \(P=\)Price). The theory of money demand transformed this identity into an equation by making \(V\) a function of some economic variables. However, the form and the arguments of the money demand function are different for different model specifications. Since \(V\) is not observable, it is proxied by \(V^*\).

\[
\ln V^* = \ln V + e
\]

where \(e\) is the random error associated with \(V^*\). It is postulated that \(V^*\) is a function of some observable variables other than \(y\), \(M\), or \(P\).

\[
\ln M + \ln V^* - \ln P - \ln y = e
\]

If \(V^*\) is a perfect proxy for \(V\), the expected value of \(e\) should be zero, i.e. \(e\) is stationary. However, the proxy, \(V^*\), may deviate from its true value in the short-run, but should converge to its true value in the long run. If the relationship among the variables in (3) is not stationary it implies that either \(V^*\) is not a good proxy for \(V\) or that there is no long-run relationship among these variables, i.e. the long-run money demand function does not exist.

The Fisher equation, in essence, implies a long-run relationship between money, real income, opportunity cost of holding real money balances, and velocity. This theoretical assertion has been tested since the late 1960s with limited success. As a matter of fact, the empirical literature on money demand function is voluminous – and also contentious.

A linear combination of the above variables,

\[
b_1 \ln M + b_2 \ln V^* + b_3 \ln P + b_4 \ln y
\]

is hypothesized to be stationary. There may or may not be a prior knowledge of the cointegrating vector, \([b_1, b_2, b_3, b_4]\). If not known, it has to be estimated.

Tests on stability of the demand for money function conducted in the studies prior to the mid-1980s were controversial.

Next, the Fisher equation hypothesizes that the cointegrating vector \([1,1,-1,-1]\), exists. This vector combines the four series into a single series \(e\). Given this assumption, we can test for cointegration by applying the unit root test to \(e\). If \(e\) is stationary, a long-term relationship between the concerned variables is valid. However, detecting cointegrating relationships among variables without any theoretical basis is relatively hard. If theory can be used to assign values \textit{a priori} to some of the coefficients, finding cointegrating relationships is not difficult. In the present case, Fisher’s equation fully specifies the cointegrating vector, and applying the usual unit root tests for cointegration is appropriate and easy to estimate the cointegrating vector.
Engle and Granger (1987), Stock and Watson (1988) and Johansen (1988) have suggested alternative tests for cointegration, and techniques for estimating the cointegrating vectors. The three procedures are quite different, but their focus is on identifying the most stationary linear combination of the vector of the time series concerned. If the numbers of time series involved are more than two, more than one linear combination can exist.

**Unit Root Tests**

Since the early 1980s the income velocity of M1 (M1/GDP) has been drifting upward, and hence, it is thought to be non-stationary. As such, the macroeconomic relationship between money (M1 measure) and income is not stable over time. The income velocity of M2 (the broader money measure) appears to be around a stationary mean, and formal tests have shown that M2 and income are cointegrated (Engle and Granger, 1987). These results are presented as evidence for the non-existence of a stable long-run relationship between M1 and income, and the existence of a stable money demand (M^d) for M2 (Hallman, Porter, and Small, 1989).

Assuming the absence of money illusion, real money demand can be expressed as:

\[ m^d = f(y, Z) \]  

where \( m^d = M^d/P \) and \( y = Q/P \)

It is also assured that the real demand for money is homogeneous of degree one in real income, so that the reciprocal of the income velocity of money is:

\[ m^d/y = g(Z) \]  

The equilibrium condition is:

\[ m^d = m^i \]  

and g(Z) is observed as the ratio of real money stock to real income.

The reciprocals of the velocities of M1 and M2 can be written as:

\[ m1/y = g1(Z) \]  
\[ m2/y = g2(W), \]

where Z is a subset of W (signifying all other variables), as M1 is part of M2. Since velocity is not observable, its proxy must be specified to conduct cointegration tests. Further, if M1 and income are not found to be cointegrated, but M2 and income are, then a stable relationship must exist between g1(Z) and g2(W).

The cointegration tests are conducted on U.S. time series quarterly data (M1, M2, GDP, GDP deflator, 3-month T-bill rate, rates on 10-year T-note) covering the period 1961.1 to 1996.1. The data were collected from various issues of the *International Financial Statistics* (IFS). M1, M2, and GDP data are seasonally adjusted.

**Results and Discussion**

The first step is the unit root test on the individual time series to determine the order of integration of each series. Unit root tests, employing the augmented Dickey-Fuller (D-F) procedure, are performed on the levels of the time series, M1, Q, 3-month T-bill rate, yields on 10-year T-note. All the variables are in nominal terms. The results of the unit root tests are in
Table 1. The null hypothesis is that the series under investigation has a unit root. The critical values by Mackinnon are used for the tests. The computed augmented D-F statistic below the critical value in absolute terms requires rejective of the null hypothesis.

<table>
<thead>
<tr>
<th>Series in levels</th>
<th>ADF Test Statistic</th>
<th>Series in their first differences</th>
<th>ADF Test Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>M1</td>
<td>-2.115</td>
<td>M1</td>
<td>-3.475</td>
</tr>
<tr>
<td>M2</td>
<td>-2.009</td>
<td>M2</td>
<td>-4.263</td>
</tr>
<tr>
<td>Q</td>
<td>-0.510</td>
<td>Q</td>
<td>-5.100</td>
</tr>
<tr>
<td>T-bill</td>
<td>-2.196</td>
<td>T-bill</td>
<td>-4.328</td>
</tr>
<tr>
<td>10-Yr. Note</td>
<td>1.994</td>
<td>10-Yr. Note</td>
<td>-5.543</td>
</tr>
</tbody>
</table>

Mackinnon Critical Values for rejection of hypothesis of a unit root

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Critical Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1%</td>
<td>-3.4770</td>
</tr>
<tr>
<td>5%</td>
<td>-3.4415</td>
</tr>
<tr>
<td>10%</td>
<td>-3.1415</td>
</tr>
</tbody>
</table>

The reported test statistics in Table 1 (column 2) indicate that the null hypothesis cannot be rejected for any of the series at the 5 percent significance level. Hence, it is concluded that each of the time series, in levels, has a unit root. The third column of Table 1 has the unit root test results on the first differences of each of the same series. The null hypothesis of a unit root can be rejected in the case of all the series 5 percent significance level. As the time series appear to be stationary in their first differences, no further tests are conducted. Hence, it is concluded that the order of integration of each of the time series is I(1).

Since each of the time series concerned is integrated in the same order, there is a possibility for cointegration between them. Cointegration tests, employing the Johansen procedure, are conducted on real M1 and also on real M2 (in their natural logs), as the dependent variable, real GDP (in natural log form), and one of the nominal interest rate variables (3-month T-bill rate / yield on 10-year T-note) as the right-hand side variables. The lag lengths for the variables, after trying a wide range, are set at four.

The test results for M1 and M2 are presented in Tables 2 and 3, respectively. The results obtained when the yield on the 10-year T-note was used are included (in the Tables), but not when the 3-month T-bill yield Wd5 was used, as they are almost the same.

The first line in Tables 2 and 3 tests the hypothesis of no cointegration, i.e. there is no long-run equilibrium relationship among the variables. As the likelihood ratio, 29.3017, exceeds the critical value of 24.31 at the 5 percent significance level, the null hypothesis of no co-integration is strongly rejected. The series in question are cointegrated.

...the empirical literature on money demand function is voluminous – and also contentious.

<table>
<thead>
<tr>
<th>Hypothesizes # of Cointegrating Equations</th>
<th>Likelihood Ratio (LR)</th>
<th>5% Critical Value</th>
<th>Cointegrating equations</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.144</td>
<td>29,302</td>
<td>24.31</td>
<td>None</td>
</tr>
<tr>
<td>0.045</td>
<td>8,150</td>
<td>12.53</td>
<td>At most 1</td>
</tr>
<tr>
<td>0.014</td>
<td>1.943</td>
<td>3.84</td>
<td>At most 2</td>
</tr>
</tbody>
</table>

Likelihood ratio test indicated one cointegrating equation at 5 percent significance level.

Normalized Cointegrating Coefficients:

<table>
<thead>
<tr>
<th>In m1</th>
<th>In y</th>
<th>R10Yr. Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.000</td>
<td>0.938</td>
<td>0.037</td>
</tr>
</tbody>
</table>

Log Likelihood: 988.214
The second line tests the hypothesis of one cointegrating vector. The maximum eigenvalue test failed to reject the null hypothesis of one cointegrating vector. So there are two common trends and one cointegrating vector. Results indicate that real M1 is cointegrated with real income and either of the two nominal interest rates.

Cointegration tests are conducted on U.S. time series quarterly data... covering the period 1961.1 to 1996.1.

Next, the normalized cointegrating vector (the first element corresponds to the dependent variable, ln m1, the second and third to ln y and nominal yield on Two-year T-notes) is close to the theoretical expectation in Fisher’s equation: that the coefficient of the real income in the long run should be equal to one in magnitude. The coefficient of ln y is 0.94, close to one. The hypothesis that the normalized coefficient on output is unity is not rejected using either interest rate, and the hypothesis of a zero coefficient for the nominal interest rate is not rejected for both interest rates.

Table 3: Johansen Cointegration Test

<table>
<thead>
<tr>
<th>Eigenvalue</th>
<th>Log likelihood Ratio (LR)</th>
<th>5 percent Critical Value</th>
<th>Hypothesized # of cointegrating equations</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.139</td>
<td>25.841</td>
<td>24.31</td>
<td>None</td>
</tr>
<tr>
<td>0.037</td>
<td>5.455</td>
<td>12.53</td>
<td>At most 1</td>
</tr>
<tr>
<td>0.002</td>
<td>0.283</td>
<td>3.84</td>
<td>At most 2</td>
</tr>
</tbody>
</table>

LR test indicates one cointegrating equation at 5 percent significance level.

Normalizing Cointegrating Coefficients:

<table>
<thead>
<tr>
<th>ln m2</th>
<th>ln y</th>
<th>R10Yr. Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.000</td>
<td>0.958</td>
<td>-0.036</td>
</tr>
</tbody>
</table>

Log likelihood ratio: 1052.209

Conclusion and Implications

The U.S. data support the asserted long-run equilibrium relationship between real M1 (and also real M2), real income, and nominal interest rates. The results allow us to conclude that the real M1 and real M2 demand functions are stable. The implication of this stability is that there is at least one common factor which influences money supply, real income and interest rates. This finding comes as no surprise, given the coordinated monetary policy of the U.S. Federal Reserve to control output and avoid inflation.

References


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3. Put an alphabetical list of your bibliographical References at the end of the article. Include only references that are used in the text.
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