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REPATRIATE ADJUSTMENT AND TURNOVER: THE ROLE OF EXPECTATIONS AND PERCEPTIONS

Pamela L. Cox, State University of New York at Oswego
Raihan H. Khan, State University of New York at Oswego
Kimberly A. Armani, State University of New York at Oswego

ABSTRACT

International placements, particularly of executives, have increased with the globalization of business. Although many global organizations have established procedures to help their employees adjust to their stays abroad, and some have established practices to provide support for returning employees, repatriate turnover continues to be a challenge for organizations. Organizations lose the skills and knowledge that repatriates gain through their foreign assignments when repatriated employees leave their jobs. With the substantial costs of training and salary for each employee sent abroad, repatriate turnover also represents a significant financial burden. This paper reviews current repatriate adjustment and turnover literature and presents a model incorporating the findings of recent research. The proposed model suggests repatriate adjustment and turnover intentions are related to the following key factors: employee expectations upon repatriation, employee perceptions of organizational repatriation support practices, and employee perceptions of the appropriateness of both job content upon return and the availability of external career opportunities based on the employee's new found expertise. Recommendations for future research are outlined as well as suggestions for improving organizational repatriation support practices.

JEL: M12, M16

KEYWORDS: International Management, Repatriation, Turnover, International Human Resource Management, Reverse Culture Shock, Re-entry Culture Shock

INTRODUCTION

International placements, particularly of executives, have increased with the globalization of business. The number of foreign assignments has grown at an exponential rate. Multi-national corporations send their managers abroad for a variety of reasons including the objective to develop their knowledge of international economic environments and increase their ability to manage in a global context (Tung, 1998). One way organizations build a pool of global knowledge and skills is to transfer their managers from country to country (Paik, Segaud, & Malinowski, 2003). The foreign assignments can provide first hand understanding of local markets, encourage cross-fertilization of ideas and practices, retain star performers in the organization by providing them with new challenges, and allow organizations to exercise control over their subsidiaries. An assumption is made that expatriate managers will return home with international expertise that will benefit the organization (O'Sullivan, 2002). Global assignments may create competitive advantage for both employees and for the companies that employ them (Carpenter, Sanders, & Gregersen, 2000). Not surprisingly, Stroh and Caligiuri (1998) found that effective management of people in the global arena positively affects the bottom line. According to Lazarova and Caligiuri (2001, pp. 389-390):

> *Repatriates, who have completed a global assignment, can help establish and expand an MNC's international business because they possess first-hand knowledge of particular cultural contexts, including information about specific markets and customers. ... Repatriates have an irreplaceable role in organizational learning, given that they can accelerate the transfer of knowledge from host countries to headquarters, and vice versa.*

A foreign assignment can be thought of as consisting of three broad stages: 1) selection and pre-departure, 2) the foreign assignment, and 3) repatriation and career management (Bonache, Brewster, & Suutari, 2001). Repatriation is defined as the return to the home country after the completion of an international assignment (Dowling & Shuler, 1990). Researchers and practitioners alike have failed to adequately address the issue of repatriating or re-acclimatizing the employee returning from the foreign assignment Although many global organizations have established procedures to help their employees adjust to their stays abroad, and some have established practices to support returning employees (Lazarova & Caligiuri, 2001), the final phase in the expatriation process, repatriation, continues to be a difficult phase for both employees and companies (Vidal, Valle, & Aragon, 2008). Repatriates experience a wide variety of issues including organizational change, career transitions, financial and family problems, and psychological stress (Chi & Chen, 2007; Harvey, 1989). In fact, repatriation can present a more difficult adjustment than expatriation (Forster, 2000; Suutari & Brewster, 2003). Repatriation can be experienced as a shock (Baruch, Steele, & Quantrill, 2002; Paik, Seguad, & Malinowski, 2002) and it can take approximately a year to a year-and-a-half for repatriates to fully adjust (Adler, 1981; Harris & Moran, 2000).

If repatriates are unable to adjust, they may leave the organization. In some cases, repatriates leave their company within two years after their return from an international assignment (Black, 1991; Lazarova & Caligiuri, 2001; Kraimer, Shaffer, & Bolino, 2009). When turnover occurs, organizations lose the employees' skills and knowledge including those gained through the foreign assignment (Bossard & Peterson, 2005). With the substantial cost of training and salary for each employee sent abroad, repatriate turnover also represents a substantial financial burden for the organization. According to the 2004 Global Relocation Trends Report, 44% of repatriates leave their companies within the first two years of returning home (Kraimer, Shaffer, & Bolino, 2009, p. 28). Black et al. (1992) found that 42 percent of the American repatriates they studied seriously contemplated leaving their organizations upon returning home, and 74 percent did not expect to be working for the same company in one year. In addition, 79 percent felt they would be able to find another job with another company as the demand for their international skills was high. While international assignments create opportunities to develop international expertise, employees are sometimes placed in jobs upon their return that do not utilize the skills and knowledge developed abroad (Harvey & Novicevic, 2006). The resulting frustration may cause repatriates to seek opportunities that are more rewarding with other firms (Stroh, Gregersen, & Black, 1998). Repatriate turnover may also compromise a company's ability to recruit future expatriates if the turnover signifies to others that international assignments have a negative career impact (Lazarova & Caligiuri, 2001).

Repatriation is a critical phase in the expatriation process. Given the costs and potential negative impacts of employees' failures to adjust following their international placements, this phase requires more scrutiny. This paper reviews current repatriate adjustment and turnover literature and presents a model incorporating the findings of recent research. Recommendations for future research are outlined as well as suggestions for improving organizational repatriation support practices.

LITERATURE REVIEW

Turnover and Intent to Leave

Significant numbers of employees leave in the two years following repatriation. Previous research supports the position that intent to stay or leave the organization is consistently and strongly related to voluntary turnover (Griffeth & Hom, 1988; Mathieu & Zajac, 1990), and has found intent to leave or stay as the strongest predictor of actual turnover (Hendrix et al., 1999; Mowday et al., 1982). Thus, in our proposed model, we use intent to leave or stay (turnover intentions) as a proxy for actual employee turnover.

Organizational Support Practices

The human resource practices of the repatriate's organization may influence the repatriate's adjustment upon return from an international assignment. The following HR practices have been found to facilitate repatriates' adjustment: having a fluent communication system, having a mentor in the domestic organization during the abroad assignment, providing training to employees prior to their return, the compensation package the company offers to repatriates, and how the organization manages repatriates' careers upon return. For example, research has found that an ongoing communication system between the home office and the expatriate reduces repatriate turnover rates (Lazarova & Caligiuri, 2001). Likewise, good communication during repatriation is critical. A qualitative study found that Spanish repatriates complained about the lack of information regarding the content of the job upon return home (Vidal et al., 2007a). There is some evidence that having a mentor during the international assignment may provide security to the expatriate and improve adjustment upon returning home (Harvey, 1982; Tung, 1988; Swaak, 1997; Hurn, 1999; Vermond, 2001). Conversely, Stroh (1995) found no support for having a mentor and repatriate adjustment. Research indicates that the timing of an HR practice may influence its outcome. Repatriates seem to value training prior to repatriation as a way to reduce uncertainty regarding the repatriation process and help to clarify the job the employee can expect upon repatriation (Black et al., 1999). Training *after* repatriation was found in one study to have no impact on repatriation satisfaction with the repatriation process (Vidal et al., 2008). Thus, it may be critical for training to take place prior to the expatriate's return home. Jassawella, Connolly, and Slojkowski (2004) found that firms that manage repatriation effectively do not simply intervene at the end of the employee's assignment but instead plan much of the repatriation activities before the employee is transferred.

Studies examining the relationship between compensation and turnover have yielded mixed results. On the one hand, Gomez-Mejia and Balkin (1983) found that increased compensation reduced repatriates' turnover intentions. Other studies found no relationship between compensation and repatriate adjustment (Gregersen & Black, 1996) or between compensation and repatriate satisfaction with the repatriation process (Vidal et al., 2007b).

The existence of a professional career plan or career management was found to reduce the turnover rate among repatriates (Lazarova & Caligiuri, 2001; Stroh, 1995). Career management was also found to increase satisfaction with the repatriation process (Vidal et al., 2008).

Vidal et al. (2008) found that professional career management, clarity in repatriation politics and practices, and accurate working expectations were related to satisfaction with the repatriation process. Satisfaction with the repatriation process was found to be negatively related to intent to leave the organization. Other studies have supported the findings that professional career management (Hammer et al., 1998; Bossard & Peterson, 2005) and having accurate work expectations (Black et al., 1999; Pickard, 1999) are important to repatriates.

Results from studies examining the relationship between how well the repatriation process has been explained and clarified (repatriation practices clarity) and repatriate adjustment have been mixed. Research from the United States and Finland found no support for a relationship between clarity in repatriation practices and repatriate adjustment (Black & Gregersen, 1991; Gregersen & Stroh, 1997). On the other hand, for Japanese and Spanish workers clarity in repatriation practices was related to repatriation adjustment (Black, 1994). Vidal et al. (2008) proposed that cultural differences may moderate the relationship. U.S. and Finnish workers may tolerate uncertainty better than Spanish and Japanese workers may.

Lazarova and Caligiuri (2001) examined organizational support practices and their effect on lowering repatriates' turnover intentions. Interestingly, they found that the key issue was not the support practices in and of themselves, but rather the repatriates' perceptions of the support practices. They collected data on HR practices most often associated with successful repatriation programs including pre-departure briefings, career planning, agreement on the type of position upon repatriation, reorientation programs, repatriation training programs, financial counseling, lifestyle assistance and counseling, continuous communication with the home office, visible signs that the company values international experience, and communication about the repatriation process. Repatriation support practices were not found to be related to either organizational commitment or repatriates' intention to leave (or to stay with) their organizations. Repatriates' perceptions of their organization's overall support practices were not related to organizational commitment. However, perceptions of organizational support practices were significantly related to repatriates' turnover intentions. These results indicate that repatriates believe company-wide appreciation of global experience and career-planning sessions are the most important repatriation support practices. These findings further suggest that the most important factors to repatriates are that the organization cares about their adjustment upon return home and has an appreciation for the experience they have acquired. De facto, repatriates' perceptions may be more important than the support practices themselves. State Lazarova & Caligiuri (p. 389):

> *We found that supportive repatriate practices offered by companies improved the repatriates' general perceptions about their companies. Repatriates who were offered more of these supportive practices, and believed that such programs were relevant and important for their successful repatriation, felt as though their company cared about their overall well-being—and ultimately, had a greater desire to remain with the company upon repatriation.*

In summary, the researchers found the following to be of particular importance to repatriates: (1) that the company articulated appreciation of global assignments and (2) offered career planning sessions. Not having these two elements seemed to result in unfavorable attitudes towards the company and increased repatriates' intentions to leave the organization. The following comments reflect these unfavorable attitudes (Lazarova & Caligiuri, p. 395):

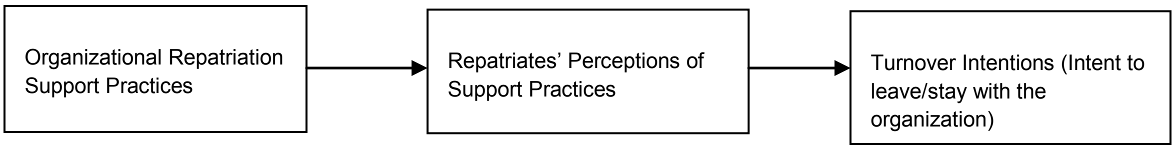
> *"Repatriation was a big disappointment. One is forced to fit back as a cog in the wheel .... North American management does not know how to exploit the talent developed abroad. Having gained experience is a premium ... I suspect a lot of [the company's] repatriates will leave within 2 years."*

> *"There was no assistance or concern about where I would return to. I think that our corporation can benefit from the experience I gained abroad, but no one asked me for any information. It is as if I never went."*

There appears to be a disconnect between the reasons stated by companies for assigning international assignments (organizational learning, acquisition of global skills, and knowledge of cultural contexts) and the actual transfer of knowledge and utilization of newly acquired global expertise upon the expatriates return to the organization. Based on our review of the literature, we propose the following:

Proposition 1 – Repatriates' perceptions of organizational repatriation support practices are related to turnover intentions. Figure 1 illustrates the elements of proposition number 1.

Figure 1: Illustration of Proposition 1



This figure illustrates the proposed relationships among support practices, perceptions of support practices, and turnover intentions.

Repatriate's Job Satisfaction after Returning Home

March and Simon (1958) proposed that employee turnover is related to the perceived desirability of the job and ease of movement. Hulin, Roznowski, & Hachiya (1985) list attractiveness of the current job and availability of alternatives as reasons for employee turnover. Mobley (1977) presented a popular model illustrating the employee turnover process. According to this model, the turnover process starts with an evaluation of the existing job. Next, employees search for, evaluate, and compare alternatives. The turnover process concludes with the employee making a decision to quit or stay. Repatriates appear to go through this process when evaluating the job assigned to them upon repatriation and determining whether to leave or stay with the organization. Repatriates most likely also assess the availability of opportunities outside the organization. In fact, repatriates may perceive the availability of external job opportunities to be quite high. In one study, 79 percent of repatriates felt they would be able to find another job with another company as the demand for their international skills was high (Black et al., 1992).

International assignments increase the external marketability of repatriates who may have acquired new skills, language proficiency, flexible management styles, and the formation of a global mindset while abroad (Lazarova & Caligiuri, 2001; Lazarova & Tarique, 2005). International employees tend to receive more external offers of employment from different organizations upon return from their assignment abroad (Lazarova & Tarique, 2005). Furthermore, individuals today may no longer perceive their career as a progression of jobs within a single organization. Instead, they perceive their careers as boundary less, and move from one company to another to pursue the best career opportunities (Parker & Inkson, 1999). These individuals will also tend to be less committed to their organizations, increasing the likelihood that they will leave the organization if job expectations are not met.

The repatriation literature suggests that being assigned a job that utilizes the employee's abilities and knowledge) is related to both job satisfaction and turnover intentions. Unfortunately, companies often do not assign repatriates a job where there is a match between employees' abilities and knowledge and job content and tasks (Bossard & Petersen (2005). In one study, 50% of repatriates found the job they held upon returning home less satisfactory than the one they held while abroad (Hammer et al., 1998). In another study, approximately 60% of repatriates felt their company did not take into account their international skills and experiences when assigning them a job upon repatriation (Peltonen, 1997). Vidal et al. (2007b) found that suitable job content upon returning home was positively related to repatriate job satisfaction. Other studies have found that repatriates often feel that their jobs upon returning home are less satisfying and that their home organizations do not value their international experience (Bolino, 2007; Hammer, Hart, & Rogan, 1998; Stroh, Gregersen, & Black, 1998).

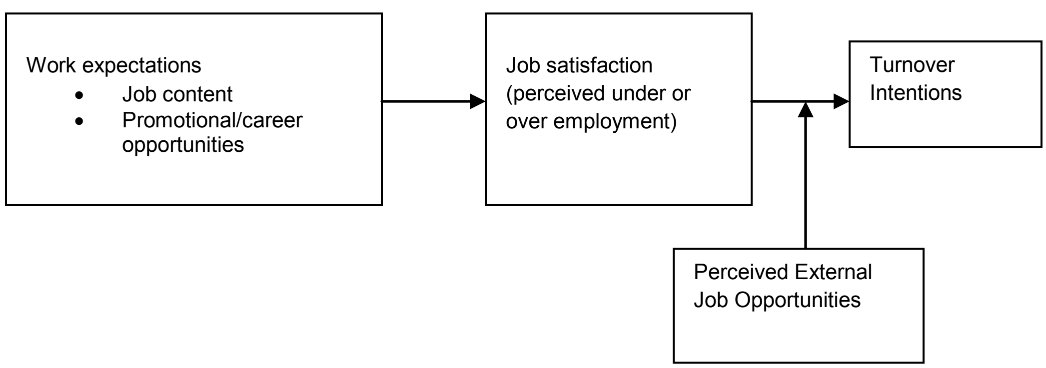
One reason that expatriates may accept an international assignment may have to do with expectations that the assignment will increase their career opportunities (Suutari & Brewster, 2003). Research has shown that expatriates who see a strong connection between their international assignments and their long-term career paths are more likely to stay with their organizations upon repatriation (Lazarova & Caligiuri, 2001; Stroh, 1995). Not receiving a promotion upon return from an international assignment may be perceived as a violation of the employee's psychological contract with the organization (Welch, 2003).

Lower career advancement opportunities within the company (relative to opportunities available outside the company) may be a predictor of turnover intentions (Stahl, Chua, Caligiuri, Cerdin, & Taniguchi, 2009). Poor career planning may result in repatriates being placed in a holding pattern and assigned jobs that may or may not match their abilities and preferences (Harvey & Novicevic, 2006). Vidal et al (2007b) found that being promoted was positively related to repatriate job satisfaction and negatively related to intentions to leave the organization. Having professional career planning available for repatriates has also been found to be related to repatriate job satisfaction (Vidal et al., 2008) and repatriation turnover (Kraimer et al, 2009). Perceived underemployment may moderate the relationship between career advancement and turnover intentions (Kraimer et al., 2009). Repatriates who perceived a promotion following their return home were less likely to experience feelings of underemployment, which, in turn, made them less likely to think about leaving the organization.

Accuracy in work expectations may be related to both repatriate job satisfaction and turnover intentions. Expectations may frequently be more optimistic than the reality presented to repatriates upon return home (Pickard, 1999), and this gap may negatively affect job satisfaction (Bonache, 2005). Accurate work expectations have been found to be related to repatriate adjustment and performance (Black, 1991; Black et al, 1999). Accurate work expectations have been found to be related to repatriate job satisfaction and turnover intentions (Vidal et al., 2007b, 2008).

Proposition 2 – Repatriate's work expectations are related to job satisfaction and turnover intentions. If the repatriate's work expectations are not met (a violation of the perceived psychological contract), job satisfaction may decrease and intentions to leave the organization may increase. The relationship between job satisfaction and turnover intentions is moderated by perceptions of external job opportunities. Figure 2 illustrates the elements of proposition 2.

Figure 2: Illustration of Proposition 2



This figure illustrates the proposed relationships among work expectations, job satisfaction, perceived external job opportunities, and turnover intentions.

Moderating Variables – Individual Characteristics and Type of Global Assignment

Individual characteristics may moderate a repatriate's adjustment upon repatriation, his/her perceptions of repatriation support practices, work expectations, and job satisfaction. These individual characteristics may include the following: age, gender, family status, culture, and personality.

Age, gender, and family status each have a bearing on the number of problems employees may encounter when they are transferred internationally (Baruch, Steele, & Quantrill, 2002). There is a consensus in the literature that younger expatriates, lacking family responsibilities and significant social commitments, have an easier time adjusting to a new job assignment (although there is also some evidence that the relationship between age and adjustment may be curvilinear) (Feldman & Tompson, 1993). Employees with families have to worry about the readjustment of others beside themselves. Poor adjustment by spouse is a key reason why expatriates return home early from their assignments (Rushing & Kleiner, 2003). An important family concern involves the trailing spouse's job (Joinson, 1998).

Family members accompanying the repatriate on the assignment may also experience reentry culture shock. Furthermore, spouses' repatriation adjustment has a positive impact on employee repatriation adjustment at work (Black et al., 1999). The family may also experience considerable pressure from family members who remained in the home country. The extended family may have to learn to interact with family members they have not seen in years, and grieve over missed periods of growth and bonding (Zvara & Singh, 2004). Animosity and blame may be directed toward the repatriate who "put the family in this situation." One study of Taiwanese repatriates found that the family accompanying the expatriate during the overseas assignment was positively related to the repatriate's intent to leave the organizations upon return (Liu, 2005). Research has also shown gender can affect success in a foreign assignment, with women being more successful than men are (Halcrow, 1999). More research needs to be done to determine the influence of gender on repatriate adjustment and turnover.

Previous research has shown that repatriation adjustment problems and repatriate turnover may vary by country. Sixty percent of American expatriates, eighty percent of Japanese expatriates, and seventy-one percent of Finnish expatriates experience some degree of culture shock upon returning home from a foreign assignment (Black, Gregersen, & Mendenhall, 1999). Participation in the local culture of the host country and a long length of stay may exacerbate problems upon return home. When employees live and immerse themselves in a foreign environment for an extended period, they are likely to adopt patterns of thinking and behaving that are characteristic of the foreign culture, creating stress and readjustment difficulties when they return home (Brislin & Van Buren, 1974). Similarly the greater the length of time a worker is away from home, the greater the chances that changes have occurred in the home country during the repatriate's absence.

The value of various repatriation support practices may vary with culture. For example, repatriates from Spain and Japan, cultures that have been found to not feel comfortable when uncertainty appears in comparison with workers from other countries (high uncertainty avoidance), valued "clarity in the repatriation policies and practices" of their firms more than U.S. and Finnish repatriates (from cultures ranked low in terms of uncertainty avoidance) (Vidal et al., 2008). Lee & Liu (2007, p. 127) suggest that Taiwanese expatriates may experience greater culture shock and reverse culture shock due to their collectivist culture. In a collectivist culture, individuals belong to only a few in-groups that are stable over time. These groups tend to be rigid and inflexible, making movement from group to group difficult. Therefore, in a Taiwanese culture, individuals may have difficulty adjusting to shifts in-group membership. Taiwanese repatriates may feel very isolated from their in-group colleagues during expatriation, making it difficult to re-establish these relationships after repatriation.

O'Sullivan (2002) proposed a model whereby certain proactive personality characteristics and behaviors may be related to the suitability of the post-return job, repatriate cultural adjustment, and turnover intentions. The proactive personality characteristics include extraversion, conscientiousness, and openness to experience, emotional stability, and agreeableness. The proactive behaviors include social networking and network seeking (both aimed at securing repatriation support and initiated both pre & post return). This model suggests that certain individual characteristics and behaviors may result in better repatriation adjustment and lower turnover regardless of other factors.

The characteristics of the global assignment may also influence repatriation adjustment and turnover. There is some disagreement as to whether the length of the assignment makes a difference. On the one hand, the shorter the period the expatriate is out of the firm's headquarters, the easier the transition to the home country may be (Lazarova & Caligiuri, 2001). Other scholars have suggested that extended assignments are desirable because they allow for better cross-cultural adjustment and improved effectiveness (Tung, 1987). Liu (2005) found no relationship between length of assignment and repatriate turnover intentions. He did find a significant relationship between number of repatriate overseas assignments; those repatriates who had had more overseas assignments and had gone through the repatriation process multiple times, adjusted better upon return. He also found that the longer the time return from the overseas assignment, the better the repatriates' adjustment and the lower the turnover intentions. Kraimer et al. (2009) found that the number of international assignments is negatively related to career advancement upon repatriation, but that this relationship flattens out as the number of assignments approaches four or more. State the authors (p. 40):

> *Thus, in our study, repatriates were most likely to get ahead in their organization when they had been on only one assignment. Career advancement was lowest among those who had between two and four assignments, and only after four assignments did there appear to be a non-negative relationship between number of international assignments and career advancement. ... Multiple assignments may damage careers because they are tagged as "out of sight, out of mind" or become thought of as permanent expatriates.*

Other researchers arrived at similar conclusions (Feldman & Thomas, 1992; Stroh et al., 1998). Stahl et al. (2009) examined the relationship of type of assignment to turnover intentions. They examined developmental assignments (learning-driven) and functional (demand-driven) assignments. Employees sent on developmental international assignments perceived their future career advancement opportunities to be better and were more inclined to leave their firms than employees sent on functional assignments. Kraimer et al. (2009) found developmental expatriate assignments to be positively related to career advancement.

Proposition 3 – Individual characteristics like age, gender, family status, culture, and personality may moderate repatriates' perceptions of organizational support practices. Individual characteristics may influence the repatriate's adjustment to home. Adjustment to home may in turn be related to turnover intentions.

Proposition 4 – Characteristics of the global assignment (length of assignment, number of assignments, and type of assignment) may influence repatriate adjustment, work expectations, and perceived external job opportunities. Figure 3 shows the proposed repatriate adjustment and turnover model.

CONCLUSION

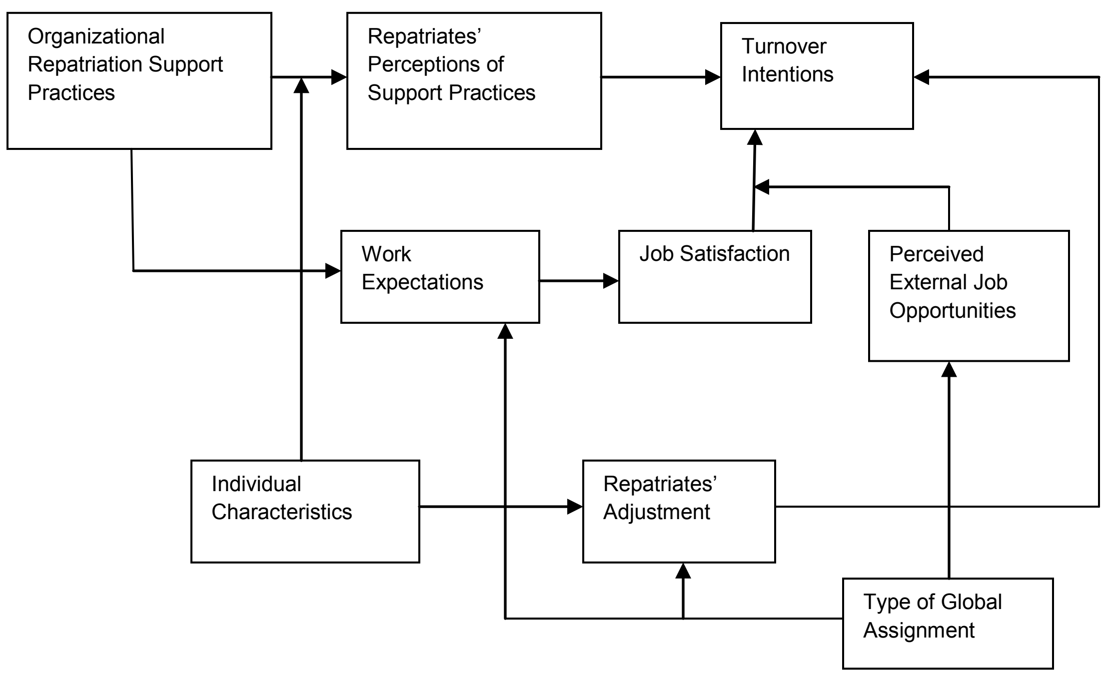
Limitations and Directions for Future Research

While this research contributes to the repatriation turnover literature by providing an in-depth literature review and proposing a model based on research findings, there are limitations to our research and the proposed model. The model relies on previous research findings that primarily surveyed repatriates who continued to work in the international companies that originally sent them abroad. Existing repatriation research uses the variable "intent to leave" as a surrogate for turnover, focusing on repatriates still employed by their companies and neglecting to survey repatriates who have already left their organizations. In addition, the model incorporates research where data collection occurred at one point in time. To overcome these limitations, we recommend that future research incorporate a longitudinal design surveying both repatriates who remain with their companies and those who have already left.

There may be bias in repatriates' answers when asked about their desire to leave their firms. Asking employees about their intent to leave introduces an inherent level of uncertainty—employees may not be forthright in their responses. What was the intent to leave for the employee before the foreign assignment? Is it possible that some employees were not satisfied with their jobs and the firm even before they left for the assignment? Employees may use international assignments as a means of gaining experience in order to move to another job with another company upon return. Conversely, employees could also intend to leave their companies before the foreign assignment and decide to stay when they return. We recommend that future research incorporate a longitudinal design measuring intent to leave prior to the international assignment, and upon return from the international assignment.

The proposed model incorporates research that studied repatriates in a limited number of countries and tended to utilize small sample sizes. This limitation affects the generalizability of the model. Research upon which the model is based should be replicated in other countries and, if possible, increase the number of repatriates surveyed. Our review of the literature indicates that not all cultural factors seem to matter equally. Future research should better identify the relative importance of cultural factors. Other individual differences like personality characteristics of repatriates need to be studied to identify the most relevant factors.

Figure 3: Proposed Repatriate Adjustment and Turnover Model



This figure depicts the proposed model of the causes and effects of repatriate adjustment and turnover intentions.

The model does not address the characteristics of the repatriate's firm. For example, do employees of large firms enjoy greater mobility and, therefore, are able to move more easily. Do some companies have a more global mindset and are more apt to provide support services for repatriates? Future research should focus on multiple companies and separate industry leaders from smaller firms.

The antecedents of repatriation are worthy of exploring in more detail. In addition to our recommendations to address the limitations of current research and the proposed model, future research might address the following questions: 1.) Are repatriates' perceptions of their organizations' support practices more important than the actual support practices themselves? 2.) Which support practices are perceived by repatriates as being most critical to their adjustment upon return home? Do individual differences like age, marital and family status, culture, and gender moderate perceptions of support practices? 3.) How do cultural differences affect repatriate adjustment and perceptions of organizational support practices? Is employee movement between certain sets of countries more difficult than others are? For example, is it more difficult to go from a collectivist culture to an individualistic culture or vice versa? Do employees from collectivist cultures experience greater repatriation adjustment problems than employees from individualistic cultures? 4.) How does the personality of the employee affect repatriation adjustment? Further research is needed to determine the impact of proactive personality characteristics and behaviors on repatriation adjustment and turnover. 5.) How do organizational support practices impact repatriate work expectations prior to and after returning home? What support practices are critical in creating accurate repatriate work expectations? And 6.) In what way do the characteristics of the global assignment moderate repatriate adjustment, work expectations, job satisfaction, perceived external job opportunities, and turnover intentions?

Based on our review of the literature we recommend the following: First, presumably, companies send employees with the greatest potential on foreign assignments for development. These employees are, therefore, among the organizations most valuable employees. Thus, because the risk of repatriate turnover is high, the most fundamental decision companies need to make is whether to send employees for developmental assignments at all. One reason, companies might not be utilizing the repatriate's newly acquired talents may be because there is no need for the skills that employees acquire in foreign assignments. Companies need to understand "global acumen" and determine whether it is needed in a particular job; furthermore, they should decide whether employees could gain global acumen *without moving to another job or country*, avoiding the problems of repatriation altogether. Another possibility is that employees obtain the wrong skills in the foreign assignments. Employers need to let employees know what they are supposed to learn in their foreign assignments. Assignments should be chosen to provide employees with experiences and exposure that will allow them to gain the skills and knowledge desired by the organization. When employees return, organizations should ask employees what they learned so that their newly acquired skills are used appropriately.

Second, when companies decide to send employees on a foreign assignment, they need to provide adequate support during both the expatriation and repatriation processes. The following practices, in particular, seem to be critical to repatriate adjustment and satisfaction with the repatriation process: having a good communication system in place prior to, during, and after the international assignment; providing employee training prior to, during, and after the international assignment; and providing career planning. Use of update emails or newsletters may be a good way of keeping the lines of communication open and having the expatriate feel a part of the home office. Communications systems, employee training, and career planning sessions should focus on creating accurate work expectations. Companies should clearly articulate support practices provided to employees prior to, during, and after the international assignment. Managing employee perceptions of organizational support practices may be just as important as providing the support practices. Above all, companies need to make sure that they articulate appreciation for global assignments and the acquisition of international skills and experience.

Third, organizations should provide repatriates with jobs upon return home that have suitable content and make use of the skills and experience acquired by the employee during the international assignment. Providing adequate career planning prior to, during, and after the international assignment can help to ensure that the employee's work expectations are met upon return home and should decrease employee intentions to pursue external job opportunities. It may be appropriate for organizations to develop systems that ensure expatriates have an idea of the position they will be returning to prior to being sent on the international assignment.

Fourth, periodic trips back to the home office to provide training and orientation to the home office staff about the practices of the foreign market could help facilitate knowledge transfer, and show appreciation for the new status and skills of the expatriate. These trips would also allow the expatriate to continue to be a part of the home office.

Fifth, organizations may want to consider varying support practices with the employee's marital and family status, gender, age, culture, and personality. Attention should be paid to not only supporting the repatriate, but also his/her spouse and family. Sixth, organizations may want to consider taking extra measures to ensure the retention of employees returning from developmental assignments as these employees may be more inclined to leave their firms than employees sent on functional assignments.

Seventh, when selecting employees to send on international assignments, companies may want to consider (and test for) proactive personality characteristics as part of the selection process. These characteristics include extraversion, conscientiousness, and openness to experience, emotional stability, and agreeableness. Eighth, employee training prior to, during, and after the international assignment should include encouraging the following proactive behaviors: social networking and network seeking.

Repatriate adjustment and turnover continue to be problematic for organizations despite a considerable body of research devoted to studying these problems. This paper contributes to the repatriate adjustment and turnover literature by reviewing the literature and presenting a model incorporating research findings. The proposed model suggests that repatriate adjustment and turnover intentions are related to the following key factors: employee expectations upon repatriation, employee perceptions of organizational repatriation support practices, and employee perceptions of the appropriateness of both job content upon return and the availability of external career opportunities based on the employee's new found expertise.

Our review of the literature suggests there is a gap between employee expectations and reality—in particular, the reality the repatriate experiences upon return home. On the one hand, organizations claim to value international assignments as a way to build a pool of global knowledge and increase the international skills of their employees. On the other hand, many organizations place repatriates in jobs upon their return home that do not utilize the global skills and knowledge acquired during the assignment. In addition, organizations may not have the support practices in place to help repatriates and their families adjust to returning home. There appears to be a disconnect between the reasons stated by companies for sending employees on international assignments (organizational learning and acquisition of global skills) and the actual transfer of knowledge and utilization of newly acquired global expertise upon the expatriate's return. Halcrow (1999, p. 42) suggests that expatriates may in fact be a "squandered" resource. In addition to proposing a model incorporating repatriation research and providing suggestions for future study, this paper offers recommendations to practitioners for closing the gap between expatriate expectations and reality, and better utilizing repatriates as a valuable organizational resource.

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BIOGRAPHY

Pamela L. Cox is a Professor of Management at SUNY-Oswego. She can be contacted at 257 Rich Hall, SUNY-Oswego, Oswego, N.Y., 13126, pamela.cox@oswego.edu, 315-312-2532.

Raihan H. Khan is an Associate Professor of Management at SUNY-Oswego. He can be contacted at 250 Rich Hall, SUNY-Oswego, Oswego, N.Y., 13126, raihan.khan@oswego.edu, 315-312-2527.

Kimberly A. Armani is the Director of the SUNY-Oswego Metro Center. She can be contacted at 2 Clinton Square, Suite 15, Syracuse, N.Y., 13202, Kimberly.armani@oswego.edu, 315-399-4100.

VALUING TARP PREFERRED STOCK

Linus Wilson, University of Louisiana at Lafayette

ABSTRACT

This is the only paper to provide a valuation framework for untraded Troubled Asset Relief Program (TARP) preferred stock. Up to $8.1 billion of bailout preferred stock, which is currently paying dividends, could be auctioned to investors. The first auction was held in March 2012. This paper provides a framework to estimate future dividend skipping rates and the rating of unrated and untraded preferred stock issues. It provides a valuation model for non-distressed issues. The model in the paper accurately predicted that the auction of MainSource Financial Group (MSFG) would raise about $53 million.

JEL: G01, G21, G28

KEYWORDS: Auctions, Bailout, Banks, Capital Purchase Program, Dividends, Hybrid Securities, Preferred Stock, Private Placements, Ratings, TARP, Troubled Asset Relief Program, Valuation

INTRODUCTION

In this note, I explain how to estimate the yield and value of untraded preferred stock. On March 23, 2012, I was asked to value the preferred stock in MainSource Financial Group (MSFG), a small lender with branches in Illinois, Ohio, and Kentucky. I estimated prior to the auction that the U.S. Treasury would raise gross proceeds of $53 million in the auction of that bank's preferred stock. That auction, which was held from March 26, 2012, to March 28, 2012, raised gross proceeds of $53,073,270.00. (I did not bid in that auction.) That was the only valuation that I did in advance of the first-ever Treasury auction of its preferred stock holdings, which were acquired in 2008 and 2009. In the next section, the relevant literature is reviewed. Next, the valuation model is developed. Finally, in the last section the note concludes.

LITERATURE REVIEW

In this note, I explain how I came to value that holding so accurately, as reported by Eiglebach (2012). My estimates were only possible with the research of Georgieva and Wilson (2010) and Carty (1995). Georgieva and Wilson (2010) estimated the propensity for publically traded banks to miss their TARP dividend payments. Carty (1995) tied the dividend skipping rates of preferred stock issuers to their ratings by Moody's.

U.S. Treasury (2012) reports that by the end of February 2012 U.S. taxpayers had already booked a profit on its largest program in the Troubled Asset Relief Program (TARP), the Capital Purchase Program (CPP). The CPP invested $205 billion in 707 banks. Since the largest banks were quicker to repay the TARP, the program had already collected more money in repayments, warrant sales, dividends, and interest than it had passed out. Thus, further receipts (even if that meant that the Treasury took losses on those individual investments) would only add to the realized profits from the CPP. 363 banks remained in the CPP after repayments, mergers, sales, bankruptcies, and conversions into other government programs. Only 310 of those banks issued preferred stock to taxpayers. The other 53 banks were S-Corps with subordinated debt outstanding.

Not all of those issues of preferred stock are likely to come up for auction in the next year or so. 148 of those 310 banks with preferred stock outstanding, 47.7 percent, had missed their most recent dividend, according to my analysis of the most recent TARP dividend and interest report. Carty (1995) found that the average preferred share, which had missed its most recent dividend, traded for 43 percent of par. The government is likely averse to realizing losses because of the bad publicity it brings. Moreover, the valuation model presented in this paper is more relevant to preferred shares that are current and likely to be repaid before dividends rise on the 5th anniversary of the taxpayers' investment. The dividend rates rise from 5 percent to 9 percent after five years for CPP preferred stock.

By February 29, 2012, there were 162 banks in the CPP that were current on their TARP preferred stock dividends with unpaid taxpayer investments with a face value of $13.0 billion. Regional banks Zions and Regions had TARP preferred stock outstanding at the end of February, but they received approval from the Federal Reserve in March 2012, according to Hopkins and Katz (2012), to repay $1.4 billon and $3.5 billion worth of preferred stock, respectively, to the U.S. Treasury. Thus, the TARP preferred stock auctions are unlikely to sell preferred stock with a liquidation preference of more than $8.1 billion. Thus, only $8.1 billion of that sum has a good chance of being auctioned to investors. The model of this paper could be of use to investors and others seeking to estimate the auction proceeds from what will likely be many more TARP preferred stock auctions.

MODEL DEVELOPMENT

To my knowledge, MSFG had no publically issued or rated debt or preferred stock outstanding at the time of the first TARP preferred stock auction. Thus, to estimate the appropriate yield of the TARP preferred stock, I attempted to estimate the rating of the preferred stock based on accounting ratios and its past dividend payment behavior. In particular, I used model 2 of Table 3 in Georgieva and Wilson (2010) to estimate the propensity of MSFG to miss its next dividend. (For privately held banks, it would be more appropriate to use model 6 in Table 3 of Wilson (2011) because that study only estimates dividend skipping behavior of privately held banks. Georgieva and Wilson (2010) exclusively looked at the dividend pass rates of publically held banks. Yet, the other steps to valuing the preferred stock would be just as the example of MSFG.) Suppose that p is the probability of missing the next quarterly dividend. That model says that the log-likelihood of a publically traded bank missing a TARP dividend was the following:

$$
\begin{aligned}
\ln[p/(1-p)] = \; & 5.0554 \\
& - 0.8646\,(\text{Return on Assets}) \\
& - 0.5523^{***}\,(\ln(\text{Total Assets})) \\
& - 0.672\,(\text{Tier 1 Risk Based Capital Ratio}) \\
& - 0.0672\,(\text{Tier 2 Risk Based Capital Ratio}) \\
& - 3.9555\,(\text{Market to Book Ratio}) \\
& + 19.4546^{***}\,(\text{Non Performing Assets Divided by Total Assets}) \\
& + 0.8390\,(\text{Cumulative Dividend Dummy}) \\
& + 1.6050^{***}\,(\text{Missed Prior Dividend Dummy})
\end{aligned}
\tag{1}
$$

That regression had 900 observations and a pseudo R-squared = 0.0765. The symbol "***" denotes a coefficient significantly different that zero with 99 percent confidence.

The cumulative dividend dummy takes on a 1 if the bank pays a cumulative dividend on its TARP preferred stock and zero, otherwise. The missed prior dividend dummy is equal to one if the bank missed its most recent TARP dividend. The MSFG preferred stock paid 5 percent annual dividends for the first five years, until January 16, 2014, when the dividend rate would increase to 9 percent per annum. The bank paid quarterly dividends in the middle of February, May, August, and November.

For MSFG the values of most of the independent variables were taken from the most recent financial report, the 10-K for year end 2011. I checked for a prior missed dividend in the most recent U.S. Treasury dividend and interest report. MSFG never missed a TARP dividend prior to the March 2012 auction. The values for the independent variables for MSFG prior to the March 26, 2012, auction were as follows:

Return on Assets = 0.0085 (2)
ln(Total Assets) = 14.829
Tier 1 Risk Based Capital Ratio = 17.60
Tier 2 Risk Based Capital Ratio = 1.30
Market to Book Ratio = 0.8268
Non Performing Assets Divided by Total Assets = 0.023672
Cumulative Dividend Dummy = 1
Missed Prior Dividend Dummy = 0

When I multiplied the independent variables in equation 2 with the coefficients from Georgieva and Wilson (2010), I got a log likelihood of a missed dividend of negative 6.55943. Suppose that the independent variables are denoted as X_1, X_2, …, and X_8. Let the intercept be denoted b_0 and the slope coefficients be denoted b_1, b_2, …, b_8. In that case, the probability of missing the next bailout dividend, given a set of independent variables is the following:

$$p = \text{Prob}(Y = 1 | X_1, X_2, \ldots, X_8) = \exp(b_0 + b_1X_1 + \ldots + b_8X_8)/[1+ \exp(b_0 + b_1X_1 + \ldots + b_8X_8)] \quad (3)$$

Let exp(Z) stand for the exponential number to the power Z. Thus, the predicted probability of MSFG missing its next bailout dividend is exp(-6.5594)/[1 + exp(-6.55943)] = 0.00141. Thus, the model predicted that the chances of missing the next bailout dividend is about 0.141%. The probability of making the next dividend is $1 – p$. The probability of making the next four dividends is $(1 – p)^4$. Thus the probability of missing a dividend in the next year is the following:

$$\text{Annual dividend passing probability} = 1 – (1 – p)^4 \quad (4)$$

In the case of MSFG, this was $1 – (0.99859)^4 = 0.005628 = 0.5628\%$.

This annual dividend pass rate is used to estimate a rating for the preferred stock. In table 1, the historic one-year dividend pass rates for various ratings of preferred stock compiled by Carty (1995) are displayed.

Table 1: One-Year Dividend Pass Rates Used to Estimate Preferred Stock Ratings

Moody's rating	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**
Dividend pass rate	0.0%	0.0%	0.7%	1.5%	5.4%	11.2%

Carty (1995) compiled average annual dividend pass rates above for preferred stock from 1980 to 1994. For example, if the one-year dividend pass rate for the preferred stock is 0.7 percent, it deserves an "A" rating. MSFG's estimated annual dividend skipping probability was closest to that of an A-rated preferred stock issue.

Thus, based on the predicted dividend pass rate, it deserved an "A" rating. Preferreds Online reported that the average A-rated preferred stock on March 22, 2012, had a yield of 5.43 percent. Thus, I used that yield to value MSFG's TARP preferred stock. At any time, the preferred stock can be called by the issuer at its liquidation preference, 100 percent of the price at which taxpayers bought the preferred stock. Since

5.43 percent is so far from 9 percent, there is almost no chance that MSFG's management will decline to redeem the preferred stock prior to the increase in the dividend rate to 9 percent in January 2014, given any reasonable estimate of the volatility of the preferred stock.

The Preferreds Online's composite yield for A-rated preferred stock reflects an index of secondary market preferred stock yields. It is well documented that investors regularly get a discount on large transactions. The TARP auction was a private placement which was exempt from SEC registration. There was to be no secondary market for the preferred stock issued by MSFG. Typically, negotiated private placements are negotiated and give investors at an 8.7 percent discount, according to Wu (2004). Yet, the TARP private placement set its price by auction.

The TARP preferred stock auctions of March 2012 were called "modified Dutch auctions." Dasgupta and Hansen (2006) explain that bidders in Dutch auctions pay the same price. In the case of the TARP warrant and preferred stock auctions, bidders submit sealed bids with their brokers prior to the auction deadline. (See Wilson (2010) and the prospectus for the TARP preferred stock offering of MainSource Financial Group at:
http://www.sec.gov/Archives/edgar/data/720002/000104746912003560/a2208504z424b4.htm

which was accessed online on March 31, 2012.) The price paid is the highest price that sells all the securities offered up in the auction. The U.S. Treasury has reserved the right to not accept the results of one of theses bailout investment auctions, but I know of no instance when the U.S. Treasury has not accepted the results of an auction and retained the securities being offered. In these modified Dutch auctions, small bidders can bid nearly up to their valuation for the securities being offered because they are unlikely to be the bidder who is marginal and drives the price. Larger bidders must be careful not to bid too aggressively because their size makes them more likely to submit the marginal bid that drives up the market clearing price.

We know from Derrien and Womack (2003) that auctions are associated with underpricing discounts that are on average 57.31 percent lower than share sales where prices are set by underwriters. Thus, they find that issuers leave less money on the table when they opt for auctions. For this auction, I estimated that investors would get a discount of .5731*8.7 percent = 4.99 percent.

I estimated the preferred stock's value as the present value of the quarterly dividends of $712,500 from May 15, 2012, to November 15, 2014, and the $57 million redemption value of the preferred stock payable just prior to the fifth anniversary of the investment on January 15, 2014. This assumes that the company rationally redeems the preferred stock before it starts paying 9 percent per annum. If the chances of the issuer's not retiring the preferred stock prior to the fifth anniversary are minimal, then the present value of the TARP preferred stock is the following:

$$
\begin{aligned}
PV = \quad & (1-u)\ \{[(PAR+[(d_a - d_n)/(d_{n+1} - d_n)]DIV)/((1+r)^{[(d_a - d_v)/365]})] \\
+ \quad & [(d_1 - d_s)/(d_1 - d_{-1})][DIV/((1+r)^{[(d_1 - d_v)/365]})] \\
+ \quad & \sum_{t=2}^{n} [\mathrm{DIV}/((1+r)^{[(d_t - d_v)/365)]})]\} \qquad (5)
\end{aligned}
$$

PV stands for present value. *PAR* is the liquidation preference of the preferred stock being sold. The liquidation preference is the amount the taxpayers invested in the bank. The *DIV* is the quarterly dividend payable prior to the 5th anniversary of the TARP investment, which is 1.25 percent of the taxpayers' investment. *r* is yield on the preferred stock, which is estimated from equations 1 and 3 and table 1 above. d_{-1} is the day after the dividend prior to the settlement date, d_v is the date of the auction, d_s is the settlement date in which winning bidders own the preferred stock, d_a is the day prior to the fifth anniversary of the TARP preferred stock, and d_t is the date of the t-th dividend after the settlement date. The n-th dividend is the last dividend prior to d_a. u is the percent discount that auction investors receive relative to fair market value because this a private placement is priced by a Dutch auction.

The first ratio on the left-hand side of equation 5 is the present value of the call price of the preferred stock and accrued dividends, assuming that the preferred stock is redeemed just before its dividend rate rise of 9 percent. The second ratio is the present value of the portion of the next dividend which has not accrued to taxpayers prior to the settlement date. For example, the auction for MSFG ended on March 28, 2012, but the prospectus says that settlement does not take place until April 3, 2012. Thus, the auction price for MSFG only reflected the portion of the May dividend that accrues between April 3, 2012, and May 15, 2012. The ratio in the summation is the present value of the second dividend after settlement and all other dividends that both follow the second dividend but precede the fifth anniversary of the bank's TARP investment. Equation 5 is only a reasonable approximation of the auction price if the preferred stock has yields well below 9 percent on the valuation date.

I calculated that $u = 0.0499$ based on the studies of Wu (2004) and Derrien and Womack (2003). According to equation 5, the estimated March 26, 2012, auction value of the MSFG stock based on the March 22, 2012, preferred stock yields was \$53.85 million. I rounded down in millions when I told Eigelbach (2012) my estimate of \$53 million.

CONCLUDING COMMENTS

This note provides a valuation framework for the untraded bailout preferred stock issued by roughly 160 banks, which are still current on their bailout dividends. More than \$8 billion of preferred stock was issued by these banks which have not repaid their obligations and are still current on their Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) dividends. U.S. Treasury (2012) reports that to date it has raised \$5.4 billion from the auction of TARP warrants to third party investors. The preferred stock auctions of these remaining, but currently dividend paying TARP banks could easily top the proceeds of the TARP warrant auctions.

In this note, I projected dividend payment probabilities using Georgieva and Wilson (2010) and use that to estimate a preferred stock rating based on Carty (1995)'s research. I valued the preferred stock until its call date, because, based on current preferred stock yields, it is very unlikely that non-distressed issuers will not choose to redeem their preferred stock when the dividend rate increases from 5 percent to 9 percent at the fifth anniversary of each bank's TARP investment in 2013 or 2014. Based on previous studies of auctions and private placement discounts, auction investors could expect on average a 5 percent discount from the estimated fair market value of the TARP preferred stock based on the estimated yield alone.

This model performed well in the first auction of TARP preferred stock, when I estimated prior to the auction that the auction proceeds would be \$53 million for the preferred stock of MainSource Financial Group (MSFG), according to Eigelbach (2012). Although there were five other issuers in the first auction of TARP preferred stock, I only valued MSFG's preferred stock prior to the auctions on March 26, 2012, to March 28, 2012. The gross proceeds of the MSFG auction turned out to be \$53 million, as I estimated.

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BIOGRAPHY

Dr. Linus Wilson is an assistant professor of finance at the University of Louisiana at Lafayette. He has published over a dozen papers on the Troubled Asset Relief Program (TARP). He can be reached at: Department of Economics & Finance, B.I. Moody III College of Business, 214 Hebrard Boulevard, Moody Hall 253, P. O. Box 44570, Lafayette, LA 70504-4570, E-mail: linuswilson@louisiana.edu, Phone: (337) 482-6209.

CHARACTERISTICS OF ENTREPRENEURS OF SMALL BUSINESS IN TABASCO, MEXICO

Norma Aguilar-Morales, Universidad Juárez Autónoma de Tabasco
María del Carmen Sandoval-Caraveo, Universidad Juárez Autónoma de Tabasco
Edith Georgina Surdez-Pérez, Universidad Juárez Autónoma de Tabasco
Sulma Guadalupe Gómez-Jiménez, Universidad Juárez Autónoma de Tabasco

ABSTRACT

The objective of this paper is to identify personal features from small businesses of commercial and service activity company entrepreneurs, as well as the factors related to how they have directed their companies and factors that have allowed them to remain in the market. The study takes place in the city of Villahermosa Tabasco, Mexico. A semi-structured interview was used as a tool to gather information. A detailed analysis of the interview results was carried out to detect the entrepreneurial characteristics of managers who. The work presents a theoretical framework, which defines manager concepts and features required to identify business opportunities and lead the company to the achievement of goals. The results identify the personal features of entrepreneurs found in commercial and services small businesses as well as the style entrepreneurs use to lead their company.

JEL: L26

KEYWORDS: Small Business, Entrepreneur, Entrepreneurial, Leadership

INTRODUCTION

Small businesses represent an important sector of economic life in a society. Some 98% of businesses in Mexico are small and medium business, and contribute considerably to Gross Domestic Product (GDP). They generate at least 64% of total employment in the country, according to figures of the Mexican Council of Standardization and Conformity Assessment. At the International level, the GEM (Global Entrepreneurship Monitor, 2008) reports that Mexico has among the greatest entrepreneurial activity of all countries. However, the same report notes that Mexico has the highest rate of cessation of activities. In Mexico, SMEs represent the majority of companies. In this research small enterprises, which nationally represent 3.5 per cent of the national total, are studied. These businesses generate 6.4% of employment and create a gross total production of 12.6% (Figure 1). This research joins others related to the profile of the entrepreneur of SMEs and provides relevant data.

García-Nieto (2008) defines the employer as a person with social and cultural attributes that creates and develops a business project in accordance with these attributes. The definition of small business varies from one region or country to another and is generally based on criteria such as the number of employees, scale of investment in equipment and machinery and production or sales volume. Small businesses are closely linked to a business practice where the operation and decisions fall upon one or two people, in most cases the owners (Tolentino, 1998). For purposes of this research, the number of employees criteria was used according to the classification of the Ley para el Desarrollo de la Competitividad de la Micro, Pequeña y Mediana Empresa (Law for the Development of the Competitiveness of the Micro, Small and Medium-sized business) from the Diario Oficial de la Federación 2002 (Official Gazette of the Federation, 2002) [see Table 1].

Figure 1: Employment Figures

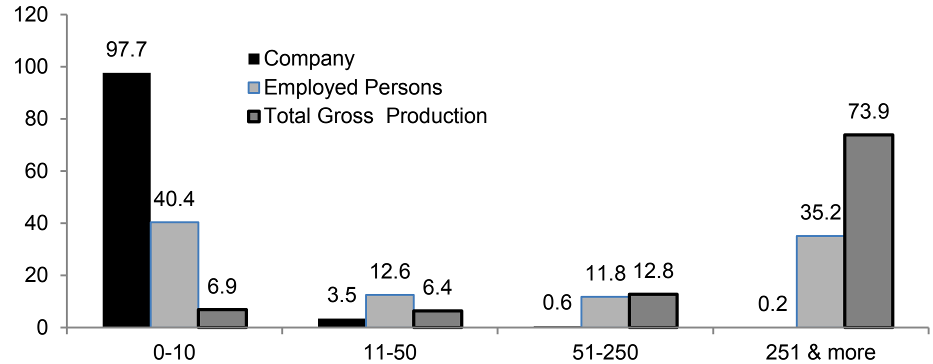

Figure shows the distribution of companies and employed individuals. Source: Instituto Nacional de Estadística, Geografía e Informática [INEGI], (2009).

Service activity enterprises provide assistance to the community and may or may not have profit. They can be classified in the following manner: Several public services: communications, energy, water, transport, tourism, financial institutions, education, health, finance and insurance. Several private services: administrative, accounting, legal services, advice. Commercial companies are intermediaries between producer and consumer. Their primary role is the buying and selling of finished products, and can be categorized as wholesalers, retailers or commission agents.

Considering the relevance that small and medium business have in job creation, its important participation in the GDP, and the lack of consolidation, it is necessary to specifically study this group. It is important to study problems in the administration of these firms, but also appropriate to identify those factors that promote their permanence. It is important to understand if they are attributable to employers or their environment (Surdez, Sandoval and Aguilar, 2007).

Table 1: Clasification of MSMEs by Number of Workers

Sector Size	Industry	Commerce	Service
Micro	0 - 10	0 - 10	0 - 10
Small	11 - 50	11 - 30	11 - 50
Medium	51 - 250	31 - 100	51 - 100

Source: Official Journal of the Federation, 2002.

The objective of this research was to identify personal skills held by employers surveyed in the study, as entrepreneurs. We link them with existing theory. We also aim is to know the factors of success of their enterprises and how they relate to their style of leadership. In this way, the experience of entrepreneurs that have managed to survive in the current economic environment will be identified and their motivations and attitudes will be known.

This work addresses these issues from the perspective of four small business entrepreneurs, two with a commercial spin and two from services. The entrepreneurs talk about their origins and business career. It consists of five sections. The introduction provides an overview of the theme, the problem, the objective is defined and the importance of the subject is highlighted. Investigations relating to the personal characteristics of the SME entrepreneurs and his style of leadership are addressed in the literature review. The methodology section explains design, type of study, the technique and instrument used in the research. The results section presents findings through tables which show the distinctive characteristics of the participants and are compared with the results of previous research. The paper closes with some concluding comments and some suggestions for future research.

LITERATURE REVIEW

When characterizing the micros, small and medium-sized enterprises (MSMEs), author (De la Rosa, 2000) considers it important to group their internal features in eight categories: The first category includes aspects related to the form of organization, management or administration. It include sfamily business, lack of intermediate management, lack of modern administrative systems, low level of formalization, high level of centralization. The second category are aspects associated with the entrepreneurs-owners who direct the MSMEs. It includes the entrepreneur who does all, little separation between capital and labor, employer enterprise view of short-term training conceived as expense and not as an investment, propensity to individual work, more intuitive than analytical businessman).

In the third category are elements related to labor, workers or the labor force. It includes rate of rotation and low payment, low level of unionization, breach of labor legislation, social distance regarding entrepreneur-worker, it is an outlet of social tensions caused by the scarcity of jobs. The fourth category includes aspects relating to financing. It includes problems in access to finance for lack of warranties, unattractive guarantees and investment projects, leverages family savings as an instrument of capitalization, it has no tax support, high return on investment, inefficient collection systems of low savings, low capacity of saving and investment, lack of capital.

The fifth category includes interrelated aspects such as technology, productivity, quality, flexibility and competitiveness. This includes obsolete and/or modern technology, it uses machinery and equipment of national origin, it faces a poor selection of raw materials and lack of inventory control, it produces with high production costs and high costs of operation, production with low value-added, reduced use of installed capacity, quality control is done visually without considering the rules and standards established internationally for the production processes and products. The sixth category includes elements linked to the market. It includes responsiveness to the demands of the market, almost zero possibility to export due to the low quality and lack of guidance and advice, uncertain tenure in the market, low level of production which affects access to internal and external markets.

The seventh category meets aspects related to the environment or the MSMEs environment. The sector is heterogeneous both organizationally and economically, the sector lives an intra and cross-sectoral disarticulation, the relationship university and/or research-business centers is poorly developed in the sector. Most MSMEs arise as a result of unemployment. It is a sector which helps the distribution of income in lower sectors of society. Characterized by a lack of networks, communication and learning among business, they are vulnerable to their economic and political environment because it is political and weak as a group. The last category includes aspects associated with the support and encouragement to the MSME. This includes null, low or high need of assistance or technical, administrative support of managerial training and human resources.

On the other hand, with regard to the distinctive features of the SME entrepreneur Surdez, Aguilar, Sandoval & Lamoyi (2012), found in their study that SME entrepreneurs are usually a young adult who started his business after completing his professional training and have acquired some experience in the course of business. MSMEs can not be generalized as a homogeneous whole because each has its peculiarities of organization and management, and each operates in different socio-economic and cultural contexts. The roles of employers in a given community are an important aspect of economic performance. They are agents of change, creators of products, services and technologies that enhance the level of the society, and contributing to satisfy the demands of formal employment. Lozano (2007) notes the focus of managers of 21st century companies is centered in owning a prospective look, a transcendental vision and in knowing how to choose the best people. This talent can be obtained by exploring skills and differentiations of people.

Tolentino (1998) argues the small-business entrepreneur-manager serves two different but closely functions: entrepreneurship and management. These functions are so rendered, that it is difficult to distinguish them from each other and separate them in practice. This is especially true in the handling of a small business. There are many theories and opinions about what makes one person have business gifts. At one extreme is the idea that one is born already equipped with entrepreneurship and instinct for businesses. On the other hand some argue that anyone can become businessman or businesswoman when circumstances offer opportunities. The business gift is that which enables people to start a new business or expand with energy and innovation an existing business (Harper, 1983; in Tolentino 1998). The entrepreneur must have some capabilities to find trade opportunities, design and launch business projects, obtain physical, financial and human resources to start business, set goals for him/herself and his/her business, and guide the enterprise and workers to achieve the goal. Table 1 shows the profile of an employer.

Table 2: Profile of the Employer

Characteristic	**Skills**
Self confidence	Confidence in own ability Independence Optimism
Will power	Persistence Perseverance Determination
Orientation towards tasks/results	Orientation towards success Work, impulse, energy Initiative
Acceptation of risks	Capacity to assess risks and accept them Liking for new challenges
Leadership	Good communicator Deals with others Accepts suggestions or criticisms Cares about others Develops others
Originality	Innovative, creative Flexible (receptive mind) Clever, versatile Experienced
Orientation towards future	Perspective, intuition
Orientation towards future	Perspective, intuition

This table presents the characteristics associated with entrepreneurs and the behaviors they manifest as his personality traits. Source: Tolentino (1998) Adapted from The Practice of Entrepreneurship by G. Meredith, R. Nelson y P.Neck, OIT, 1982.

Tjosvold and Weicker, (1993); in Tolentino (1998) mentions that entrepreneurs forge ties between his small business and the surrounding environment. This is done on the basis of formal and informal networks of family members, friends and businesspeople to obtain information, support and essential resources for the foundation and functioning of the enterprise. These networks are critical to detect opportunities, test ideas, acquire data and knowledge on best practices, mobilize resources to create the new company, help the entrepreneur and business keep current with current trends, learning new technologies, assess the changing trends of its clientele and develop new ways of addressing problems.

Another point of view of entrepreneurs is put forward by Galbraith, (1998; in Sanabria and Burgos, 2004), who admits the existence of two large social entrepreneurship structures. One relates to the notion of a traditional company and its products, in which the maximum profit is a synonym for survival and for which marketing is priority. The other relates to the notion that a company can be initiated on the basis of innovation and its creative destruction schemas (Schumpeter, 1997; Sanabria and Burgos, 2004), or quasi-monopolistic structures, or company of knowledge and increasing yields. The same author mentions that business and entrepreneurship should be by definition competitive and there can be no obstacle to the freedom of access to information. Beyond the accepted intellectual property rights, business does not necessarily include direct ownership of resources and monopolization. The same enterprising attitude can lead to the pursuit of innovation in the absence of restrictions on access to resources efficiently and effectively. This is the basis for the renewal and the search options unnoticed by others.

The theories that speak of the formation of new companies, include the incubator theory (Carrasco 2003). This theory argues the entrepreneurial phenomenon is addressed on the analogy of a person's life cycle and can be distinguished into three phases: pre-natal, birth and post-natal. It argues that new companies do not arise automatically but require a period of time in which the idea or business opportunity matures and in which their chances of success or failure contrast the particular environment. If the previous process concludes positively, the possibility of the birth of a new company appears. When the company demonstrates it can live by itself and the entrepreneur focuses on developing a strategy for growth, the post-natal stage there will be reached. Carrasco concludes by saying, that in this context the majority of research focusing on the phenomenon of business incubators tend to establish a connection between business organizations in which the entrepreneur and the new company have been working. He argues that those serve as incubators for new business projects, because herein is where the entrepreneur, in a number of occasions, discovers the business opportunity and matures his idea to materialize it into a company.

It is also important to note that employer's leadership style influences the success or failure of the company. For that reason a theoretical review on the subject was carried out. The leader is a person who participates in the organization, modeling his future and is able to inspire others around him to accomplish new tasks and seek new challenges (Senge, 2006). According to the Drucker Foundation (2007) leadership is the ability to direct others to benefit of the objectives of the organization, mobilizing subordinates around themselves. Davis and Newstrom (2003) argue leadership is the process of influencing others and getting them to work with enthusiasm in the achievement of objectives.

There is a plethora of theories about leadership. For the purposes of this research two approaches are considered. Transactional leadership (Hollander, 1978) occurs when followers are motivated for the benefits expected by the achievement of the goals or tasks assigned. Transformational leadership (Bass and Avolio, 1990) is related to the impact on people to whom it leads, and identifying change as the main function of leadership as it guides its followers and inspires them through the establishment of challenges and gives motivation based on personal development of those who follow it.

Transformational leadership encourages people to do more than they originally expected of themselves. It is characterized by four factors (Bass, 1990). Idealized influence imitates the behavior of the leader, who shows self-confidence, self-esteem and responsibility. People rely fully on him. Inspirational motivation leaders inspire, giving meaning to action, to work. They elevate the emotional level of people surrounding them. Individualized consideration provides care to the person as the unique and only one he/she is. The leader needs empathy, active listening, dialogue, and interest for people to develop this facet. Intellectual stimulation, encourages the reason of colleagues and intellectual development. It involves people having a different view of things, reviewing existing premises and assumptions. Leadership style has an impact on group work in the organizational environment process and therefore in the results of the organization. Similarly leadership style is related to efficiency in large, medium and small companies, particularly in the latter, since those decisions are generally taken by a single person, who is the owner at the same time (Rodriguez, 2007).

DATA AND METHODOLOGY

This research is qualitative, with a non-experimental design. The type of study is descriptive. The technique of information-gathering used was story of life, consisting of written or oral enunciation of a narration of his life or part thereof (Comejo, Mendoza and Rojas, 2008). It is an interview that looks for knowing the social through the individual (Díaz, 1999). Such is the expression of a living being, which is recognized as such and narrates events, evokes experiences, feelings and emotions in a concrete way and sends a message to others (Enríquez, 2002). Information processing was made through content analysis technique and it is presented in charts. Four in depth interviews were made in the period November 2010 -April 2011.

RESULTS

After analyzing the life stories and extracting sentences a summary of the results are presented in Tables 3 through 12.

Table 3: Sociodemographic Conditions of Business

Entrepreneur	Age	Sex	Marital Status	Educational Level	Family Business Background
Employer 1 (services turning)	30 years	Male	Married	Bachelor's degree	Yes
Business woman 2 (commercial turn)	55 years	Female	Single (widow)	Bachelor's degree	Yes
Entrepreneur 3 (commercial turn)	50 years	Male	Married	Bachelor's degree	Yes
Businessman 4 (commercial turn)	52 years	Male	Married	Bachelor's degree	Yes.

In this table it is possible to observe that the majority of employers are mature adults, predominantly male. They are married, have an undergraduate degree and all possess a business family history. Source: own elaboration.

Table 4: Entrepreneurs Factors Expressed in the Conduct of Employers

Entrepreneur	Feature
Employer 1 (services turn)	Ambition and initiative Dedication to the business Take risks Family values Hard work Like for what it does Knowledge Previous experience
Business 2 (commercial turn)	Ambition and initiative Dedication to the business Hard work Family values Knowledge Previous experience
Entrepreneur 3 (commercial turn)	Ambition Initiative Overcoming wishes Dedication to the business Hard work Perseverance Knowledge Previous experience Put the soul in what it does Print your personal touch Working independence
Businessman 4 (commercial turn)	Previous experience Ambition and initiative Confidence in the staff Knowledge

This table shows personal characteristics that distinguish each employer. It also shows what has contributed to the success of their business. Source: own elaboration.

Table 5: Employer 1 (Service)- Success Factors Attributable to the Employer

Factors	Information obtained from the interview
Ambition and initiative.	"The company started on August 9, 2000 as a project of entrepreneurial students who were studying the major of computer systems at the Universidad Juarez Autonoma de Tabasco, in Cunduacán, region Chontalpa, " "The project lasted one year and we saw that we liked it and that it was attracting many customers and after a year an independence was made, the other person who started the project with me put his branch and so the company began in 2000. This year we are 8 years old already."
Family values	"The kindness, honesty... values in general, most of them are from my family, they let me keep and acquire more goods."
Knowledge	He demonstrates the ability to manage his business with knowledge gained in his school education. "Here, I am more than anything... to be a specialist in management career, but I am in charge of... all consumables, all management staff... the cash management... I have an accountant because he is responsible for that part, and I try to have a good treatment of my personal so that people feel comfortable here..."
Hard work.	He is dedicated to his business "full-time"
Family and business background	Influence of background of family dedicated for years to small business service "Yes, it influenced because... I was working there for about 8 years and I have the habit.
Family support	Family support has been there since he started his business both economically and morally. "Highly motivated, they gave me great support, which I could count on, economically and for example, they always mentioned that if something happened, they could speak to someone, get a friend to advise me or teach me things that I didn't know, but yes, they showed me great support."
Spouse Support	He has the support of his wife as they studied the same technical major. "Yes, we studied a technical major in UT together, and she studied the telemetric area; and she supports me in anything here, at least, but she supports me, for example to make cuts, inventory and customer service"
Love for what he does	He believes that for success it is essential: "If you focus on what you like, work makes it easy and you do it with pleasure"

This table presents the perception by the employer of a small company of computer services of the personal factors that have contributed to the success of his business. Source: own elaboration.

A number of factors related to the way in which managers direct their business were also be detected. The results are presented in Table 6.

Table 6: Employer 1 (Rotation Service)- Factors Attributable to Managerial Style

Factors	Information obtained from the interview
Quality in service	He cares a lot about the needs of its customers. "Good care, more than anything we are looking for having a good service... help with the needs of our customers... we are always updating… also the good prices have helped us a lot, our customers are very constant, they have attracted other customers for the service we give and... that's a point we favor, the good care more than anything else."
Development of his staff	He provides support to their employees because they are students. "Until now, we have 2 people who have already 3 years working with us and we care of their studies; to enable them to do things properly and do not make us look bad with customers"
Good relationship with suppliers	His suppliers help us to update on new products. "We have received support from our supplier of equipment, in order to sell more hey teach us new technology, bring us new products, and hence we will update."
Diversification of products and services	He handles a wide variety of products and services trying to offer their customers a complete service. "Here we have the service of PC, rent of internet, printings, scans, rent of consumables that are cd ' s, floppy disks, stationery... also we have technical support, which means equipment maintenance, maintenance of companies, development of websites, networks, sale of consumables, sale of computer facilities of computer such as USB flash drives, hard drives, flat screens, laptops, anything."

This table presents the perception by the employer of a small company of computer services of the management factors that have contributed to the success of his business. Source: Own elaboration

Table 7: Businesswoman 2 (Service Turn)-Success Factors Attributable to the Entrepreneur

Factors	Information obtained from the interview
Family heritance	"Look, my dad was actually who founded the company, he now owns several businesses, we are now owners also and we take care of them."
Family entrepreneur background	"My grandmother was a primary school teacher and my grandfather had a grocery store but never succeeded." My father began to work as employer as a private accountant at a gas station, he received no inheritance of anyone and the basis of everything was the vision a person may have, the determination and also, you know what? Savings that you can have. He always tells me "this is for your family, this is to save".
Time for business	"Full time"
To have always a vision	"We must have the vision that we won't always be an employee." We have to work hard, be here, not to leave others our business, if you do not have resources, you begin as an employee but save. "If you have the will to work you have to carry out, much time and effort".
Family Values	"To work hard and save much, if we had 20 pesos, well we had 20 pesos, do you understand?"
School knowledge obtained	"Profession: tourist business administration but also has accounting and administrative knowledge also service to the public"
Previous experience	"I had no experience, I acquired it through the work, because this is through the work and that's all".
Hard work	"As I said much work, much determination." "You see, for example when the price of gas raises every month. I had to be there those days since very early in the morning".
Business family background	Influence of family background dedicated to various businesses for years, dad and brother have companies in the family.
Family Support anytime	Family support has been since she started her business both economically and, morally since the company is her father's inheritance. "It's a family business and all we have supported ourselves in all aspects. The success comes from the trunk which is my dad from whom we have support after my paternal grandmother, she died and my mom is a great moral support."

This table presents the perception of the entrepreneur of a gas station company and automotive services on the personal factors that have contributed to the success of his business. Source: Own elaboration.

Table 8: Businesswoman 2 (Services Turn) Factors Attributable to Managerial Style

Factors	Information obtained from the interview
Savings	She considers that which has given success to her business have been two factors: hard work and savings.
Hiring os staff	"It happens that sometimes people come to find a job, but they want at first a high position and big salary, actually this is obtained through time and work. In fact, some have told me that the job is not what they believed. I always try to let them know what the job is about and propose them to stay some time to see if they can meet their ambitions, sometimes they have stayed and others they have not.
Training	"I believe that we are at the forefront, we are updated as they have skills especially in service to the public."

This table presents the perception of the entrepreneurial of a gas station company and automotive services on management factors that have contributed to the success of his business. Source: own elaboration.

In the commercial turn entrepreneurs life-stories, the characteristics identified are presented in Table 9. We also identified a number of factors related to the way in which entrepreneurs of commercial management manage their business. These results are reported in Table 10.

Table 9: Businessman 3 (Commercial Turn)- Success Factors Attributable to the Entrepreneur

Factors	Information Obtained from the Interview
Experience	Knowing a little about the field where they would work helped them. "However him, knowing the market and what the system of computer was, he talked with us and told us that Villahermosa, Tabasco is a place where you can work and you can have future enterprises"
Training for obtaining resources	Planning the proposal and finding the necessary means. "The two other people, a relative and myself decided to put the capital thus the company could be financed and it began to work"
Capacity to deal with others	Different attitudes in each partner who have contributed to the permanence of the company.
Perseverance	"Well, in the case of Jorge, he is very skillful to interact socially and that is important here in Tabasco. "He is very persistent in how to bind any customer relationship that is very important".
Ability to take derection	"I say that in my case it is the fact to make determinations and execute them."
Hard work	To entirely focus at his work even until the morning. "I am here full-time, I sometimes get to my house at one o'clock in the morning, two-three in the morning; this is depending on the negotiation of table 4 x 4 we make because sometimes matters are discussed like that "
Positive attitude	Wanting to learn is important. "I don't get scared if an employee does not know doing things because he can learn, me what does scare me is that he does not want to do things, attitude, that is what counts in any company.Then if you don't know, but you want to, you are going to do it, but if you know and you don't want to, you are not going to do it."That's what has been key."
Ability to solve problems	Taking the right decisions at the right time sacrificing to face with any situation. "There were some employees who were not paid completely, and no. My motto is "that one works is because he needs it and payment is sacred"

This table presents the perception of the partner 1 of a trading company of industrial equipment on aspects of his personality that have contributed to the success of the business. Source: own elaboration.

Table 10: Businessman 3 (Commercial Turn)- Factors Attributable to Managerial Style

Factors	Information obtained from the interview
Organizational Change	"First of all the organization was important. We had to change the organization, we had to change management, and we had to start delegating responsibilities. A change in the organization had to be made in order to provide greater results."
Training of control	Each one has a specific role in the enterprise trying to keep track of all the details. "We are dedicated to give maintenance to what is autonomous respiration, equipment which is used by firefighters in case of fire, they are use masks." Gas detectors when there are gas leakages. "He is dedicated to give maintenance to this type of equipment."
Participatory decision-making	"At least now there is a little planning, before everything was spontaneous and the one who was in turn, took the decision or consulted the two that were there and due to pressure, they could sometimes decide badly "
Building trust with customers	He believes that the best recommendation is by oneself. But as I say, things occur by themselves, this guy came and I recommended me with his heads and I have been working until now. This is what I tell you about the way of being of each one, giving confidence without needing to ask for many explanations
Good organizational environment	Always maintain a pleasant environment of work and positive attitude. "Our phrase was:" the most important thing for us is you"
Knowing of the market	To have the possibility to grow more rapidly as an enterprise. "Taking into account the experience that Jorge had, because when the company where he worked closed, logically he had customers, he already had had suppliers, he knew the market, he knew the State, the environment and that would allow him to drive more rapidly and we can grow as a company"
Fixing of goals.	Ongoing motivation to his staff for increasing production. "Your earn some amount of money so that you can be profitable you have to sell another amount, that's it, we began to reach goals because before we used to work up without goals, and now we started to have goals and apart from that logically if your work more you have the right to earn more, if you bring me a customer you have the right to... - we started talking about economic stimuli - your bring, you have to earn, it is not only the company which has to grow".
Job quality	Attitudes to launch a business. "especially eager to work and doing things well only because there are times that you recommend yourself for your work" "That one has interest because there are people who do not know but ask: this is for what?" Where can I get it? How is it used? "So that next time he does it alone and has that initiative."

This table presents the perception of the partner 1 of a trading company of industrial equipment on management factors that have contributed to the success of the business. Source: own elaboration.

Table 11: Businessman 4 (Commercial Turn) Factors of Success Attributable to the Entrepreneur

Factors	**Information obtained from the interview**
Previous experience	"I worked in a company with my brother, for 5 years, something related to wood"
School experience	"I studied the degree in administration of companies in the Instituto Tecnológico de Villahermosa”.
Ambition, initiative, willing of successing.	"I had concern and desire to succeed by myself, with the sale of cedar, which obviously even there were people who told me: “you won't do anything”, but you see, I've had a pretty good time"
Knowledge obtained at school	His profession is in Management of companies, but he considers that knowledge of accounting, taxation, etc. are necessary too: "in management you get a little information, but it isn't enough"...
Constant job	“Full time”
Family background in business	“My parents had a shop in Balancán and my father had a farm and livestock”.
Family support all the time	He was supported by his family at the beginning of his business: "my dad provided me some money, he had his ranch and livestock, and he gave me $60,000.00 or $70,000.00. I bought two trailers of wood".
Support of his couple	He has the support of his wife: "As I said, this is a project of my wife and mine, it is also a family business, my wife, undoubtedly, has supported me in all our life together, since the beginning of the business working with me".
Care about the business, to print a personal seal	He believes that for success it is essential: "the perseverance, I had some stumbling and I´ve been perseverant, I don’t care about driving, or whatever, I don't have any kind of prejudice that prevents me to develop as what I am now, if you have to carry something, I do it, if you must be a professional, I am one, have printed a personal seal to my company, nothing happens if I do what my workers do, I am not alone on the desktop, I go out and tell them how to do things".
Knowing how to separate the company’s money and the family’s money	"After three or four hours of audits we had, we learned very well the management of resources, with the Secretariat of Treasury and finance, and we learned that there is way to dispose of resources, but legally, that means, not to take the money of the business for tuition fees, for household expenditure, it cannot be".

This table presents the perception of the partner 2 of a trading company of industrial equipment on personal characteristics that have contributed to the success of the business. Source: own elaboration.

Table 12: Businessman 4 (Commercial Turn) Factors attributable to Managerial Style

Factors	**Information obtained from the interview**
Confidence, and service quality	He cares much about the needs of its customers. "An area which is essential, attention to the public, it is the first contact with the customer the first impression that you take is important, it is which moves the client threads". "Be loyal customer, we do not lie anyone, we offer table of first and second quality, with price of first and price of second, this is essential because it creates confidence, this is the most success of business: confidence". "You need to know how to implement and generate and starting to see competence around you, go to see the range of products that make you grow and we realized that, that and the most important thing that made us to grow, we need to give a good service if you come with us and you are provided with a good service with excellent quality".
Importance of the staff	He considers that the staff is important for your business: "First are employees, over the years we have tried to comply fully with all our obligations, the distribution of profits is to pay, because the worker’s money is for him, if there are utilities they are divided, they see customers every day and know very well if there are utilities, and when there are not, they also realize it".
Support of suppliers	Its suppliers sometimes give credit: all or almost all providers offer 30 days, they tell me, take 30 days or more, the essential thing is to know how to manage credit... and take care of the credit.
Saving and use of credit	"Occasionally bank credit, we have banking credit lines, the essential thing is to know how to handle credit... and take care of the credit, we have saved money to avoid such situations".
Variety of products and services offered to the customer	He handles as a product the sale and purchase of wood, including good service, trying to offer their customers a complete service: "what I want to see is that carpenter shop triplay table sheets and tell me they need nails that he needs need varnishes, the sandpaper, the locks, and that he arrives here and finds everything, so that he will go full and happy, because if we began to sell wood and the triplay, we sell also plug-ins so that he does not go with the competence".

This table presents the perception of the partner 2 of a trading company of industrial equipment on administrative factors that have contributed to the success of the business. Source: own elaboration.

When relating the obtained information in the stories of life with the queried theoretical concepts, it can be seen that there are multiple coincidences. We also identified information not been mentioned by them. The interviews revealed that entrepreneurs have the following characteristics: Confidence in themselves, force will, orientation towards tasks/results, acceptance of risk, perseverance, leadership

Also, according to Tjosvold and Weicker, cited by Tolentino, entrepreneurs forges ties of his small business with the environment that surrounds him on formal and informal networks of family and friends. The results here are consistent with this concept. We found the four entrepreneurs were supported by their families and teamed up with friends for their business. Also highlighted in both theory and results here, is the capacity to gather resources and to be a good troubleshooter.

The results show the influence of family values, corporate background of the family, the support of the couple, love for what they do and positive attitude. These factors are important, since they are directly related to the way of being of the employer. This finding gives us a wider idea of the influence they exercise in their decision to launch a business. Entrepreneur 2 (rotation service) noted a strong family influence from the father and no spousal support because he is a widower. Personal characteristics of entrepreneurs from both turns are not very similar. This can be influenced by various aspects such as gender, family and economic background and internal motivation, which coincide with De la Peña, to a greater extent in entrepreneurs 1,3 and 4.

Carrasco, expressed the role of personal life cycle related to the creation of enterprises. He also expresses that enterprises do not emerge from nothing. Rather the idea has a period of incubation, which is usually developed during previous working life of the employer. It can be seen that there is coincidence with what was found in the research here since two entrepreneurs (3 and 4), had previous experience in the course of their business and this motivated them to undertake their business venture.

It was found that there is no coincidence with what De la Rosa expressed regarding the separation of capital and labor. Entrepreneur 4, mentioned that he did make this separation and had a long-term vision. Similarly, De la Rosa expresses that entrepreneur owners of MSMEs do not comply with legislation, which contradicts that found with this same operator. The same happens with financing, since it expresses that it has lines of credit used rationally, preferring the savings for self-financing.

With regard to quality and technology, the results are not as expected. The employer makes a rigorous selection in his raw materials, he purchases it abroad, but there is match in the statement made by De la Rosa about heterogeneity of MSMEs. This implies that each one is unique in its operation, which gives guidelines for analyzing the businesswoman 2 (turn services) case in which a completely different situation is shown. Since having inherited the business, she has few features that other entrepreneurs possess. She has professional skills, but they are not precisely according to her business, she was very concise in all her responses and in most of the situations, she referred to her father, who was the founder of the company.

With regard to the style of leadership the following information was found. A businessman of services turn (entrepreneur 1) and one of commercial turn (entrepreneur 4), are more focused on transformational leadership type. They are concerned about the development of their staff. At the same time, another businessman of commercial turn (entrepreneur 3), has a style that is a combination of transactional (he negotiates with his employees the economic incentives based on new customers they attract), but he also has some transformational leadership because he is change-oriented. Besides, he exerts a participatory take of decision making, concerned about maintaining a good organizational environment. On the other hand, the businesswoman of services turn (businesswoman 2) does not show defined leadership features and does not give much relevance to her staff because she shows a certain attitude of indifference toward the rotation of the staff.

CONCLUDING COMMENTS

This research identifies personal characteristics that distinguish entrepreneurs and the factors of business success related to their style of leadership. It was confirmed that personal characteristics of individuals influence their success as entrepreneurs. This finding is consistent with findings by Tolentino (1998). Similarly, the present study proves the wealth of the qualitative method, which allowed, through the stories of life, to identify in depth characteristics that identify each employer. Throughout the study some limitations related to access to informants were found. Other limitation of the study include conditions of insecurity in the country, which results in employer hesitancy to share personal information with anyone; the insistence of the researchers paid fruits, since finally the data could be obtained.

This research reflects the reality with which small commerce and service businesses operate in the city of Villahermosa, Tabasco, Mexico. We study the point of view of its entrepreneurs, being able to find some features that identify them and that the literature does not mention or does not give them importance. The style of leadership exercised in the conduct of their business was identified. Transactional and transformational types are the most important. We identify the way in which these styles influence their organizations and the results obtained. Employer 1, of services, is a young person, whose only job experience is that acquired in the business of his parents and his own business. Likewise businesswoman 2, only has experience in the business she inherited from her father. Contrary, commercial turn (3 and 4) entrepreneurs are people with wide work experience. Entrepreneur 1, of turn of services, despite his lack of experience, he has been able to consolidate his business and keep it on track. Enterprise commercial turn (3), in spite of the experience of its commerce partners, has suffered serious problems with its administration. It can be concluded that personal characteristics, rather than experience, have a major impact in the style of leadership exercised and at the same time this affects results that the company gets.

The results open new lines for future research about the entrepreneurs of SMEs. The methodology used here can be replicated in other populations and contexts of study that will serve as a reference for training entrepreneurs in the academic context.

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BIOGRAPHY

Norma Aguilar is a Professor of Administration at Universidad Juárez Autónoma de Tabasco, División Académica de Ciencias Económico Administrativas. She can be contacted at: Av. Universidad s/n Zona de la Cultura, Col. Magisterial C.P. 86040, Villahermosa, Tabasco, México. Email: gialca@hotmail.com

María del Carmen Sandoval is a Professor of Administration at Universidad Juárez Autónoma de Tabasco, División Académica de Ingeniería y Arquitectura. She can be contacted at: Carretera Cunduacán-Jalpa de Méndez Km. 1 C.P. 86690, Cunduacán, Tabasco, México. Email: sandovalcaraveo@yahoo.com.mx

Edith Georgina Surdez is a Professor of Administration at Universidad Juárez Autónoma de Tabasco, División Académica de Ciencias Económico Administrativas. She can be contacted at: Av. Universidad s/n Zona de la Cultura, Col. Magisterial C.P. 86040, Villahermosa, Tabasco, México. Email: edith.2109@hotmail.com

Sulma Guadalupe Gómez is a Professor of Languages at Universidad Juárez Autónoma de Tabasco, División Académica de Ingeniería y Arquitectura. She can be contacted at: Carretera Cunduacán-Jalpa de Méndez Km. 1 C.P. 86690, Cunduacán, Tabasco, México. Email: sulmagomez2002@hotmail.com

HYBRID CLOUD MANAGEMENT: FOUNDATIONS AND STRATEGIES

Peter Géczy, National Institute of Advanced Industrial Science and Technology (AIST)
Noriaki Izumi, National Institute of Advanced Industrial Science and Technology (AIST)
Kôiti Hasida, National Institute of Advanced Industrial Science and Technology (AIST)

ABSTRACT

Adoption of cloud-based systems has been relatively modest—regardless of significant marketing push by major public cloud providers. The cloud-based model utilizes distributed information technology services accessible over networks. The networks can be internal part of organizations' infrastructure—intranets, or external, such as internet or mobile networks. Utilization of internal networks and services is preferred by organizations—private clouds. External networks and services provided by public cloud providers pose significant risks. The major risks associated with public clouds are security, control and accessibility. In public clouds, valuable organizational data can be compromised and damaged by external entities. Organizations utilizing public clouds lose control over their critical data and services, while external entities gain control. Furthermore, external networks are inherently insecure, monitored and substantially less reliable than organizational intranets. Despite numerous disadvantages of public clouds, there is a potential in combining private and public cloud systems—hybrid clouds. Hybrid clouds present unique challenges and possibilities. We explore pertinent aspects of hybrid clouds and introduce suitable strategies for their effective management. Such actionable knowledge is essential for managers of information technologies.

JEL: M15, O14, O32, O33, L86, K12, K23, K42

KEYWORDS: Hybrid Clouds, Cloud Hybridization, Cloud Management, Cloud Computing, Cloud-based Services, Information Technology Management, Actionable Knowledge

INTRODUCTION

Organizations cannot rely on public cloud systems for their valuable data and services—it is too risky. Many organizations had to learn this lesson the hard way; for example WikiLeaks. The WikiLeaks' case clearly exposed the risks of adopting public cloud computing model and services (Sternstein, 2011). WikiLeaks contracted Amazon's public cloud services for hosting web content and data. After years of service, Amazon abruptly removed WikiLeaks' data and content, and terminated their services due to controversial issues. This happened simply based on the inquiry by US federal lawmakers without any legal proceedings (MacAskill, 2010; O'Connor, 2010). Businesses worldwide were stunned with Amazon's behavior—and accordingly adjusted their perspective on public cloud services. Amazon had already bad reputation for reliability. Amazon's cloud service outages and data damages have been causing numerous problems and economic losses for organizations (Bright, 2011; Clark, 2011; Musil, 2011).

Google extends the dangers of public cloud services to entirely new levels. It is well know that Google collects excessive amounts of data via their web and mobile services, intentionally tracks users across web sites, devices, and even geographically—via global positioning satellite sensors, geolocation and wifi network location technologies. Google has entrenched hostility to privacy (Privacy International, 2007). It bypasses privacy settings and undermines any regulatory initiatives aimed at privacy, data protection and retention (MSDN, 2012). Google also employs numerous questionable practices to accumulate increasingly more data about users, businesses and governments (Doctorow, 2012; Mfonobong, 2012;

Loftus, 2012). Google then analyses, processes and explores the collected data for its own economic benefit without any regard or concern for the original sources. Placing any data on their servers means complete loss of control and significant exploitation. The message is clear: public clouds pose risks that organizations cannot afford.

Despite surmounting dangers of public clouds, cloud computing is still considered a promising trend. Understandably, the primary advocates of public cloud services are the public cloud providers themselves. However, public cloud systems are not the only ones available to organizations. There are three main cloud architectures: public, private and hybrid. Each one has its own benefits and risks. The most beneficial are the private clouds. Conversely, the most risky are the public clouds. Hybrid clouds represent a combination of private and public clouds. They have a potential to balance their inherent risks and benefits. Managing cloud adoption requires significant considerations and planning (Géczy et al., 2012). Properly managed and deployed hybrid cloud-based systems can alleviate operational efficiency of organizations.

Organizations devote notable resources to information technologies. Information technologies, resources and services are among the core constituents of knowledge-intensive organizations (Alvesson, 2004). Knowledge workers increasingly rely on information technologies for their work (Ringel-Bickelmaier and Ringel, 2010; Davenport, 2005). Considerable investments in information technologies attract various providers—including cloud providers (Marston et al., 2011).

The cloud service model resembles the outsourcing model. By outsourcing non-core services to cloud providers, organizations should gain economic benefits. The outsourcing costs should therefore be lower than the corresponding information technology investments. Since cloud providers offer services to a number of organizations, they employ the economy of scale to lower their operating costs and achieve reasonable margins (Kambil, 2009). The analogies to outsourcing models are straightforward and appear rational. However, there are numerous challenging issues requiring careful considerations.

This study addresses important issues for practical adoption of hybrid cloud architectures. It is organized as follows. First, we present a literature review and a historical perspective; then, we introduce the hybrid cloud model. Hybrid clouds have both inherent and unique benefits and risks. We concisely outline pertinent benefits and risks associated with hybrid clouds in the section 'Characteristics of Hybrid Clouds'. This risk-benefit analysis opens avenues for effective managerial strategies. The section 'Actionable Managerial Strategies for Cloud Hybridization' introduces actionable knowledge crucial for feasible deployment of hybrid cloud systems. This enables effective decision-making and allows managers to assess the key strategic points. Discussion of the key points and conclusive remarks are provided in the final section.

LITERATURE REVIEW AND HISTORICAL PERSPECTIVE

Cloud computing is nothing new—technologically (Howie, 2010). It merely represents a suitable merger of already existing technologies. The technologies enabling cloud computing have been available for a relatively long time. In fact, what is called a 'cloud computing' today has been known as a 'distributed computing' to information technology professionals for decades (Cubitt et al., 2011). Then, why suddenly cloud computing (or distributed computing) re-emerged as a promising contemporary information technology trend? To answer this question, one has to gain a perspective on how information technologies have paved their way to organizations, and how information technology companies built and utilized their services.

Organizations have utilized various approaches for information technology adoption; however, there are common points. In early days, each organization had its own way of building information technology resources and infrastructures. This period is characterized by relative absence of information technology departments and hence also absence of coordinated long-term strategy and planning (Butler and Murphy, 2007). Individual departments had been implementing their own information systems and infrastructures. It had been sufficient to meet only the local requirements of individual departments (Palanisamy et al., 2010). However, information technology companies provided multi-purpose hardware and software. This led to multiplicity of systems at various departments that had overlapping functionalities and components, but lacked interoperability (Papastathopoulou et al., 2007). Rapid progress in information technologies required frequent upgrades. Information technology costs had been rising sharply. The challenge was to bring the costs under control and optimize deployment of information technology resources.

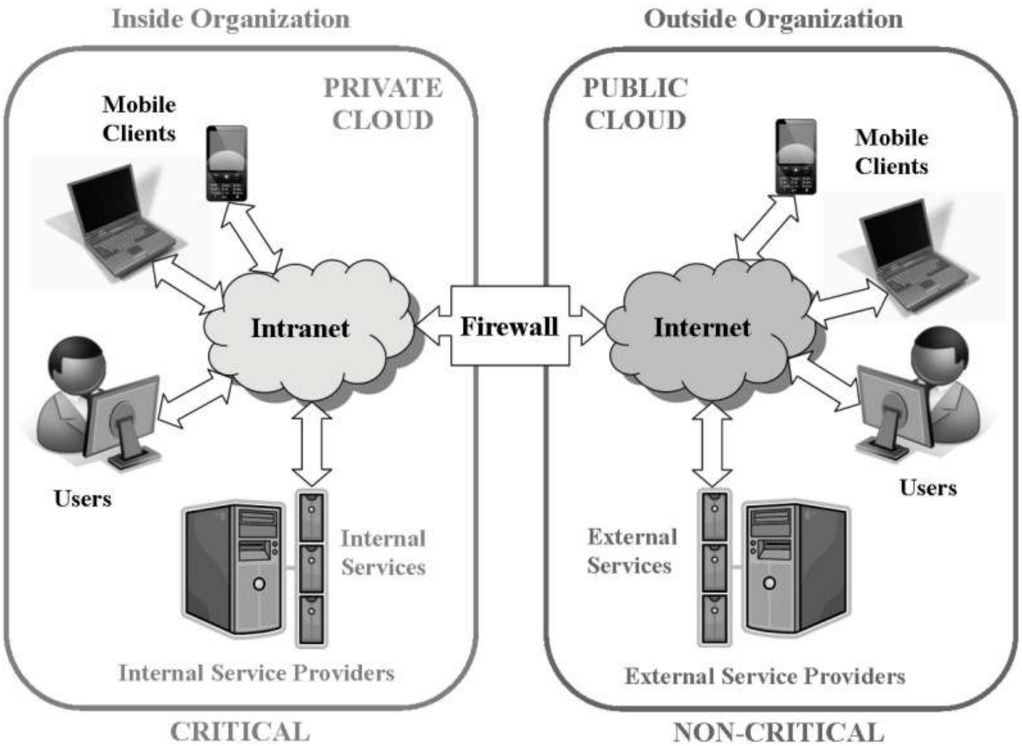
The necessity of coordinated planning and deployment of information technologies in organizations has emerged (Georgantzas and Katsamakas, 2010). However, radical changes to already deployed systems would impede operating efficiency of organizations. Solutions that would utilize existing, often legacy technologies, have been preferential. A viable solution has been found: organizational portals that provide single-point access to systems and services distributed among various departments (Oertel et al., 2010; Sullivan, 2004; Collins, 2000). Portals have featured uniform front-end interface to a variety of back-end implementations. The technological enablers for portals have been standardized network communication protocols, web technologies, and service-oriented architecture and design (Rosen et al., 2008).

Uniform front-end to distributed resources and services (together with networked access) are the main characteristics of cloud computing (Linthicum, 2009). Services can be accessed via local intranets, or via global internet. Hence, in the networked environments, the service providers can be both inside and outside of organizations. Internal provision of services over local intranets refers to private clouds, while external provision of services over internet refers to public clouds. This permits sufficient specialization of both external organizations and internal data centers on providing *on-demand* services (Iyer and Henderson, 2010). The providers can optimize their infrastructures and resources to reach higher efficiency. However, cloud-based systems have associated risks and benefits (Subashini and Kavitha, 2011; Hamlen et al., 2010; Julisch and Hall, 2010). Security, control and legal protection of data and services are among the most important aspects for organizations (Anthes, 2010; Lanois, 2010).

Hybrid Cloud Model

Common characteristics of cloud-based models are on-demand supply of resources and services, their distributed nature, and access over networked infrastructures (Rimal et al., 2011). Resources and services are provided according to the need of organizations or users. The needs may vary over time. Cloud-based implementations should respond to dynamically changing needs (Goscinski and Brock, 2010). Cloud-based environments should be dynamically scalable. Dynamic demand for resources should be automatically matched by appropriate supply. On-demand provisioning of resources and services allows flexible accounting. Organizations and users pay only for what they use. This is advantageous if the use significantly fluctuates.

Figure 1: Hybrid Cloud Model Illustration



Cloud-based models feature distribution of information technology resources and services both internally–inside an organization and externally–outside an organization. The hybrid cloud model contains critical services and resources inside organization. They are provided internally and accessed over local intranet. Non-critical services and resources are located outside organization. They are supplied by external providers and accessed over public internet.

Services and resources are distributed both physically and logically. Physical distribution refers to different geographical locations and/or hardware. For example, data centers hosting hardware can be build in different geographical locations. Locations are chosen according to availability of energy resources, skilled labor, suitable legislation and economic incentives. Logical distribution underlines distribution on the same hardware. This is achievable via virtualization technologies (Loganayagi and Sujatha, 2011). Several virtual environments can be present concurrently on a single hardware resource. Virtualization system maintains separation among individual virtual environments.

Cloud-based services and resources are generally accessed over communication network infrastructures (Frischbier and Petrov, 2010; Haeberlen, 2010). Communication infrastructures are owned and provided by various operators. For instance, mobile operators provide wireless access while other communication companies provide wired access. Global network access is over internet. Organizations have also their own local networks—intranets. Services and resources are accessed over these various networks by standardized protocols. Higher-level standardization facilitates accessibility over different networks.

Three main cloud-based models are commonly distinguished: private, public and hybrid. They differ in accessibility, ownership and location of cloud-based environments. Illustration of cloud-based models is presented in Figure 1. The left-hand side shows essential configuration of private cloud architecture, while the right-hand side shows the public one. Combination of private and public clouds underlines the hybrid cloud architecture.

Private clouds are the most beneficial for organizations (Orakwue, 2010). Organizations can exercise full control over their data, services, resources and infrastructure. The private cloud environments are owned by organizations and hosted within their premises. Services and resources are accessed over local intranets. Local organizational intranets are presently the most reliable, secure and available network environments. Private clouds are also the most economical in the long term.

Public clouds are the most risky and disadvantageous for organizations (Hofmann and Woods, 2010). Organizations lose control over their valuable data, services and infrastructure. These essentials are outsourced to external providers. Organizations must compromise on numerous key issues, since services and information technology resources are owned by external entities. Valuable organizational data and services are exposed to significant security risks because they are hosted by external providers and accessed over internet and/or mobile networks. Internet and mobile networks are presently the most unreliable and insecure network environments. They are monitored by various entities. Thus, valuable organizational data is exposed. Unreliability of internet and mobile networks leads also to accessibility risks. If internet or mobile connection is not available, users cannot access critical data and services. Public cloud environments are the most expensive in the long term.

Hybrid clouds represent a combination of private and public clouds (Sotomayor et al., 2009). Organizations should maintain control over their critical data, services and infrastructure. Non-critical elements can be outsourced to external provides. Critical organizational data, services and infrastructure to access them are kept in-house. The critical services and resources are accessed over local intranets that provide secure and reliable connectivity. Residual non-critical data and services may be outsourced. They are located at infrastructures of external providers where they are exposed to significant risks. Accessibility of non-critical resources is via internet and mobile networks that are insecure and have low safety factors. Hybrid clouds provide opportunities to balance short term and long term costs.

Characteristics Of Hybrid Clouds

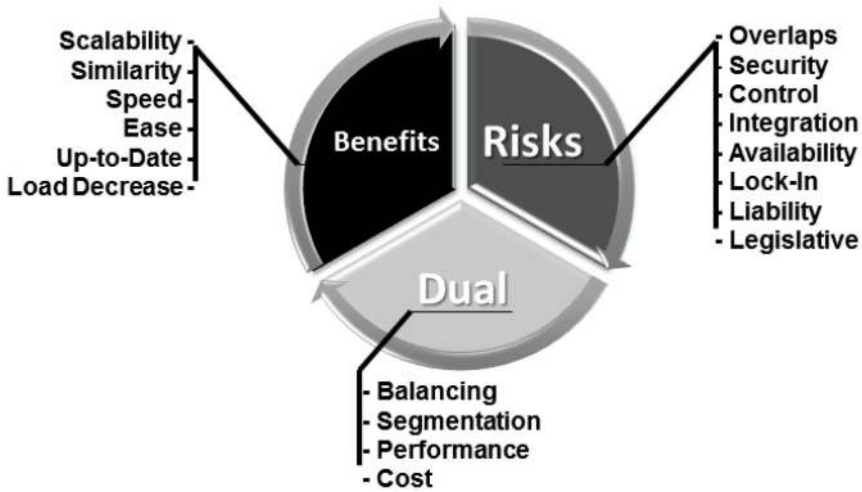
Hybrid cloud systems inherit various characteristics from both private and public clouds. Moreover, the unique combination of both cloud architectures presents some specific issues. Some specifics relate to links between both private and public cloud architectures, others arise from the resulting hybridization. Primary characteristics of hybrid cloud systems are listed in Figure 2. They are concisely described in the following subsections.

Benefits

Hybrid cloud-based systems have various benefits. Majority of benefits are inherited from its private cloud segment. Primary concerns for organizations and users are security and control of their valuable data and services (Anthes, 2010). While private cloud systems provide the most secure environments for organizational data and service, introduction of public cloud segments exposes organizations to significant security risks. Hence, the primary benefits in purely private cloud adoption scheme become potential risks in hybrid cloud configurations. Benefits of hybrid cloud systems relate to their structural features (scalability, similarity and load decrease) and temporal aspects (speed and up-to-date actualizations).

Scalability. Cloud systems are scalable. Information technology resources can be dynamically allocated on-demand. When demand increases, more resources are provided, and when demand decreases, resources are reduced. This permits efficient utilization of resources. Hardware and software resources can be scaled on-demand. Scalability is possible by employing virtualization and modularization technologies. These technologies allow dynamic management of available information technology resources.

Figure 2: Essential Characteristics of Hybrid Cloud Systems



Hybrid cloud systems feature essential benefits and risks. Furthermore, they possess characteristics that account for both potential risks as well as benefits—depending on proper assessment and implementation of hybrid cloud architecture.

Similarity. Adoption of cloud-based architectures is similar to outsourcing. Outsourcing experience provides viable higher-order perspective on cloud adoption. Managers with outsourcing experience and expertise should be competent to assess issues related to cloud adoption. Although there are differences between outsourcing and cloud adoption, information technology managers should be able to adapt fast. They should be capable of weighting risks and benefits of clouds with respect to their organization and users.

Speed. Cloud-based systems and services can be deployed fast. Most of the public clouds are specifically designed for fast deployment. Available private cloud systems are also rapidly deployable. There are ample ready-to-use packages suiting various needs of organizations and users. Information technologies and systems are modular. Modularity facilitates fast deployment and expansion.

Ease. Cloud-based systems are easily deployable. Contemporary technologies permit easy and fast deployment. Hardware, in majority of instances, is the same as or slightly different from the conventional server, cluster and modular systems. Analogously, software solutions for management of cloud-based systems are built for easy use and adaptation. Hence, the information technology managers with experience in modern server systems are able to adapt to new conditions with ease and speed.

Up-to-Date. Information technology solutions for cloud-based systems are kept up-to-date easily. In public cloud systems, software, hardware and related infrastructures are professionally managed and maintained at the side of providers. They are kept up-to-date by professional technicians. Private cloud solutions require in-house maintenance and management. Fortunately, majority of cloud-based solutions feature automatic update options. Thus, organizations and users are timely provided with the latest stable environments.

Load Decrease. Hybrid clouds enable decrease of various loads within organizations. Resource intensive services that are not among the core competencies of organizations can be moved to public clouds. This decreases load on private cloud systems. Analogously, large number of available information resources and data at organizational systems contribute to information overload. These can be managed effectively and dynamically by cloud-based systems.

Risks

Hybrid cloud environments present several significant risks. The main risks are inherent in the public cloud segment (Subashini and Kavitha, 2011; Lanois, 2010). Private clouds are the safest. However, incorporation of public clouds in hybrid cloud systems lowers the safety of the overall system. The major risks, inherent in public clouds, are security and loss of control. Proper control and management of valuable data and services are of the primary importance for organizations (Julisch and Hall, 2010; Hamlen et al., 2010). While private clouds allow full control of data and services by organizations, use of public clouds results in loss of control. Therefore, it is pertinent to assess which data and services are outsourced to external public cloud providers. Additional risks are availability of services, integration and legislative issues.

Overlaps. Data and services utilized by private and public clouds should be disjunct. Ideally, there should be no overlaps. Each cloud system should contain its own data and services. Utilization of private cloud systems exposes organizational data and services at substantial risk. Existence of overlaps increases the risk. For instance, if data is compromised in the public cloud, it affects also data in the private cloud; hence, the whole system is affected.

Security. Inclusion of public cloud segments results in security risks. Outsourcing organizational data and services to external providers exposes them to high risks. The external providers gain access to organizational data and services, and may compromise them—either intentionally or unintentionally. Additional risks relate to access of services and data in public clouds over internet and other insecure communication networks. These communication networks are monitored by various governmental and corporate organizations. Traffic is regularly intercepted and compromised despite the use of secure protocols and encryption. Several legislations, including the United States, even prohibit, limit or neutralize encryption standards and secure protocols.

Control. Control over valuable data and services is essential for organizations. It is therefore pertinent that organizations strive to maintain it. In private clouds, organizations have the complete control. However, in public cloud environments, the control is lost. External public cloud providers gain control over data and services. Organizations must compromise on notable aspects of their data and services and often follow regulations set up by public cloud providers. These may be in contradiction with internal organizational regulations.

Integration. Services provided by cloud-based systems should integrate well into existing information technology frameworks and workflows of organizations. Interfaces, data structures and communications should be compatible with the existing formats, data structures and communication protocols used by the organization. Incompatibilities result in various operational problems. Later-stage resolution of incompatibilities may be costly and time consuming. Cloud-based systems and providers should incorporate relevant integration services.

Availability. Availability underlines accessibility of services and resources. Services and resources should be accessible fast—whenever needed. Since cloud-based services are accessed over networks, reliability of networks plays significant role. If network connection is unreliable, services may become inaccessible. Local organizational networks are considerably more reliable and faster that global internet and mobile networks. Hence, public cloud services are less reliable and accessible than private cloud services. Therefore, the core services and resources requiring high availability should be in private clouds.

Lock-in. Ability to relocate organizational data, services and resources fast and easy is essential. However, lock-in is a business strategy of majority of public cloud providers. To start using their services is easy, but to transfer organizational data, services and resources from their platforms is not. Public cloud providers erect artificial barriers for organizations and users. Moving away from their platforms becomes troublesome, time consuming and costly.

Liability. Public cloud providers protect themselves by legally distancing from possible liabilities. Organizational data, resources and services are exposed to significant risks at public cloud providers' platforms. Valuable organizational data may be damaged, compromised and exposed to undesirable entities. Their services may become inaccessible causing notable losses for organizations. Unfortunately, organizations and their members have only very limited or non-existent legal protection. Contractual terms of service of public cloud providers are formulated in such a way that they cannot be hold accountable and liable.

Legislations. Cloud-based systems and services are distributed. Distributed nature of cloud-based model provides numerous advantages, but inevitably brings up the issue of diverse legislations. Data centers of public cloud providers are physically located in various geographical locations. The choice of locations is influenced by several operational and legislative factors. Providers choose locations with legislations favorable for them, but not for organizations to which they provide services. These are often locations with inadequate or non-existent legislations for data protection, privacy, and other important issues. Hence, valuable organizational data and services may be on servers in locations with non-existent legal protection.

<u>Dual Issues</u>

Certain aspects of hybrid cloud systems are not clearly polarized. They cannot be straightforwardly characterized as risks or benefits. They can be either risks or benefits depending on implementation and/or deployment. Specifics of cloud system implementations determine their positive and negative values as well as their benefit and risk factors. Balancing and segmentation characteristics are unique features of hybrid cloud systems. Performance and cost are inherited features from private and public components. These characteristics are highlighted in the following paragraphs.

Balancing. Determining and maintaining a proper balance between private and public cloud systems is vital. Inappropriate division and utilization of individual cloud segments may lead to notable deficiencies and operating inefficiencies. Extensive public cloud segment provides significant exposure to risks. The major risk factors have been formerly described. It is important to minimize risks to manageable levels. Certain system designs and configurations may be more cost effective, but incorporate higher risks. It is not advisable to compromise on security of data and services—even in cases of higher initial costs. Security, control and reliability aspect should be prioritized.

Segmentation. Services and resources in hybrid cloud systems are divided among private and public components. Proper division of information technology resources, in addition to data and services handled by each cloud component, is important. There should be minimal overlaps between data and services (unless the overlapping aspects are desired for redundancy purposes). Critical organizational data and services should be always in private clouds. Division of data and services between private and public clouds results in fragmented control and customization. Extensive fragmentation is undesirable. Private clouds provide full control and can be customized to suit organizational needs.

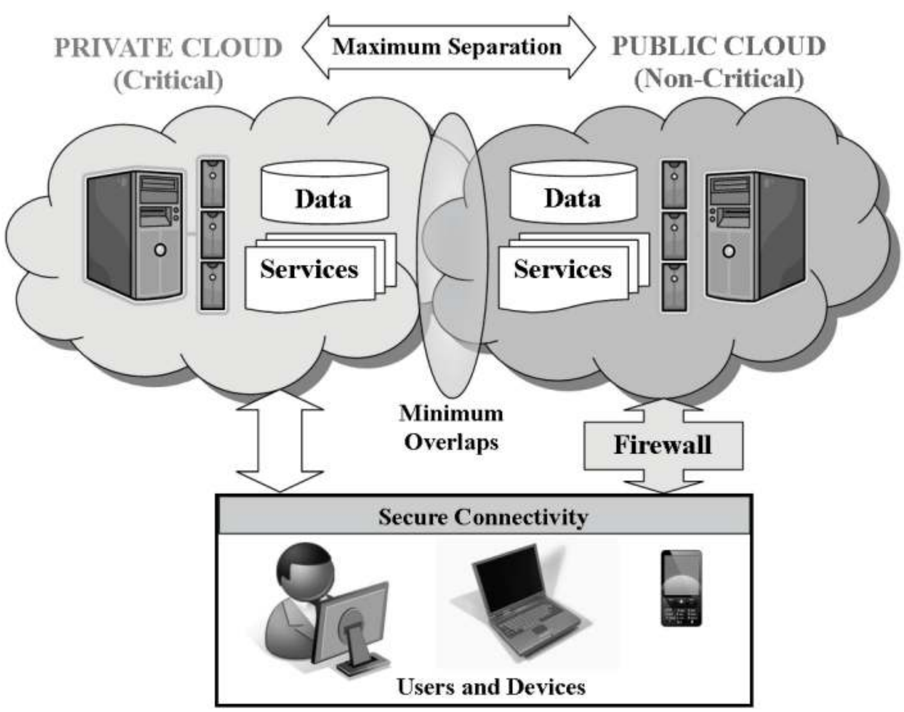
Performance. Performance of cloud-based systems is dependent on available information technology resources. Organizations that can devote more resources to their information technologies should aim at maximizing their private cloud segment. Organizations with fewer resources may initially employ larger public cloud component, but should aim at expanding their private cloud systems and minimize exposure to external public cloud providers. Services and resources should have satisfactory performance allowing users to perform their tasks. They should also be scalable with growing user base and computing demands. Outsourcing residual services to external providers may help to free resources in private cloud and improve its performance for core services.

Costs. Costs in hybrid cloud systems are divided between private and public parts. Generally, private clouds are cost efficient in a long term, but may require higher initial costs. Public clouds are not cost efficient in a long term, but require lower initial costs. Hybrid cloud configurations enable greater flexibility in balancing short term and long terms costs. Organizations can reduce their initial costs and spread expenses more suitably over their planning periods. Since public cloud services frequently employ utility-style payment schemes (organizations pay only for the resources and services they used), costs may be easily estimated and effectively planned in both shorter and longer terms.

RESULTS: ACTIONABLE MANAGERIAL STRATEGIES FOR CLOUD HYBRIDIZATION

Necessary precursors to hybrid cloud system deployment are significant considerations and planning. While hybrid cloud systems may fit certain organizational needs, they may be unsuitable for others (McKinney, 2010). Large and medium size organizations should aim at implementation of private clouds from the beginning, or as early as possible. Information technology managers should cautiously weigh whether the incorporation of a public cloud dimension is worth the risks (Marston et al., 2011). There are numerous other aspects to consider. The essential actionable knowledge and strategic principles for viable hybridization of cloud systems are depicted in Figure 3.

Figure 3. Depiction of Strategic Cloud Hybridization Management Principles



Proper management strategies for adoption of hybrid cloud systems should aim at maximum separation and minimum overlaps of data and services at private and public clouds. The strategic considerations should target balancing security, control, legal protection and long term economic benefits for organizations.

The main advantage of hybrid clouds is the capability to balance inherent risks and benefits in its private and public segments. The major benefits originate from the private clouds. The public clouds bring the highest risks. A viable hybrid cloud adoption strategy aims at maximizing benefits, minimizing risks, and efficiently maintaining suitable long-term balance. The primary focus should be on three essential points: maximizing separation between private and public cloud components in terms of data and services, minimizing overlaps among data and services, and enhancing segregate end-to-end secure connectivity for both clouds. These strategic management concepts are detailed in the following paragraphs.

Maximum Separation: Public cloud segment poses the greatest risks. Valuable organizational data and services are exposed to external entities and may be compromised. Thus, it is essential to maintain the maximum possible separation of data and services in the public and private clouds. Exposure to public clouds should be only for the data and services that are residual and non-core for efficient functioning of organizations. The core data and services should be in the private cloud in-house. The separation should be maintained preferably at both physical and logical levels (Loganayagi and Sujatha, 2011). Hardware and software infrastructures utilized for accessing data and services in private and public clouds should be segregated.

Minimum Overlaps: Total separation of public and private cloud systems may be difficult to achieve. If the complete separation is not achievable, it is advisable to minimize overlaps of data, services and infrastructures that are exposed to both public and private cloud systems. Overlaps elevate security and control risks primarily associated with external public cloud providers. Minimization of overlaps minimizes potential risks. Bridging systems between private and public clouds should be appropriately monitored for any data leakage, damage and exposure. Furthermore, the gateways to external public cloud systems should be suitably monitored as well.

End-to-End Secure Connectivity: Security is among the most important issues. The primary security risks are due to exposure to external public cloud providers. Services and resources hosted in the external public cloud systems are accessed over global internet or mobile communication networks. These networks are thoroughly monitored by the providers and several other entities. Traffic in these networks is routinely intercepted and analyzed. Any data exchanged between an organization and a public cloud provider is essentially exposed to a wide range of risks. Encrypted communication partially lowers the exposure level. A mistake made by organizations is that secure connectivity is provided only for the external traffic. Interception and compromisation may also happen internally. It is therefore pertinent to secure the complete communication path, that is, to employ secure end-to-end connectivity.

Cost Effectiveness: Organizations should aim at long-term cost effectiveness while balancing short-term costs. Private cloud systems are long term cost effective, but require higher initial costs. Public cloud systems may be cheaper in a short term, but become expensive in a long term. Present-day public cloud services are often economical for less than two years (Mann, 2011; Morton and Alford, 2009). Hence, the strategic target for information technology managers is to achieve full efficiency of private cloud systems within two years. Exposure to external public cloud services should be drastically minimized after two years.

DISCUSSION AND CONCLUSIONS

Elucidation of hybrid cloud systems revealed various pertinent strategic issues and considerations. Hybrid cloud systems comprise of private and public cloud components. Information technology resources and services in the private cloud segment are owned by the organization that utilizes them. Infrastructure, hardware and software are hosted inside the organization. Public cloud systems employ the opposite concept. External providers that own the underlying infrastructure, hardware and software provide services. Hence, the hybrid cloud systems utilize both internally and externally provided and owned resources and services.

Combination of internally and externally provided and owned resources and services presents both benefits and risks. Various risks and benefits are inherent in public and private segments. However, the unique combination of public and private cloud systems brings up specific challenges. The majority of inherent benefits arise from the private clouds. Conversely, the majority of inherent risks originate in the public clouds. The most important issues for organizations are security and control of data and services. While private clouds allow full control and better security, public clouds provide notably lower security and control of data and services. Major unique issues of hybrid cloud systems are fragmentation and overlaps of data and services between their public and private components. Information technology managers must carefully weigh both inherent and unique issues prior to adopting hybrid cloud architectures.

Suitable adoption of hybrid cloud systems should aim at balancing benefits and risks with respect to the local conditions of organizations. Hybrid clouds have a potential to balance inherent and unique risks and benefits. Balancing benefits and risks requires an appropriate strategy. A general strategy is to maximize benefits and minimize risks, while maintaining operational effectiveness of the hybrid cloud systems. This approach exposes managerial domains that require attention. Pertinent strategic targets are fourfold: maximum separation of private and public clouds, minimum data and service overlaps among cloud architectures, secure end-to-end connectivity and cost effectiveness. Maximum separation of data and services between private and public clouds lowers the risk of undesirable exposure and loss of control. Minimum data and service overlaps address both fragmentation and security issues. Secure end-to-end connectivity between users and services for both public and private clouds lowers unwanted exposure of valuable organizational data and services. Cost effectiveness leads to the issue of balancing short and long-term costs. Organizations should target long terms cost effectiveness of cloud systems. This means maximizing the efficiency of private clouds within two years while minimizing exposure to external public cloud providers.

Presented characteristic features of hybrid cloud systems highlighted selected important aspects. However, there are additional aspects that exceed the scope of this work. Information technology managers should be aware of the additional conditions (with respect to their organization) and incorporate them into the introduced strategic framework.

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BIOGRAPHY

Dr. Peter Géczy is a chief scientist at the National Institute of Advanced Industrial Science and Technology (AIST). He can be contacted at: AIST, 2-3-26 Aomi Koto-ku, Tokyo 135-0064, Japan.

Dr. Noriaki Izumi is a chief scientist at the National Institute of Advanced Industrial Science and Technology (AIST). He can be contacted at: AIST, 2-3-26 Aomi Koto-ku, Tokyo 135-0064, Japan.

Dr. Kôiti Hasida is a group leader at the National Institute of Advanced Industrial Science and Technology (AIST). He can be contacted at: AIST, 2-3-26 Aomi Koto-ku, Tokyo 135-0064, Japan.

ENVIRONMENTAL SUSTAINABILITY IN THE 21ST CENTURY: AN ASSESSMENT OF TRINIDAD'S BUSINESS TOURISM MARKET

Narendra Ramgulam, University of the West Indies
Koshina Raghunandan-Mohammed, University of the West Indies
Moolchand Raghunandan, University of the West Indies

ABSTRACT

The aim of this paper is to provide an understanding of business tourism and its contribution to environmental sustainability. This paper discusses the concept of business tourism and captures the environmental impact of this niche market. It examines the viability of business tourism as it relates to environmental sustainability in Trinidad and makes recommendations, which includes policy propositions for the future. Additionally, an examination of New Zealand's environmental strategies are presented to determine whether Trinidad can espouse these and embrace environmental sustainability in its business tourism industry. From this qualitative study utilizing a thematic analysis, it was determined, that business tourism was environmentally sustainable and should be pursued as a micro sector for diversifying the Trinidad and Tobago economy. The findings also revealed that there are potential benefits when countries actively pursue business tourism that is in harmony with environmentally friendly practices. It also embraces the notion of sustainability as a way forward and proposes an environmentally friendly happiness valuation model for the way forward.

JEL: M31

KEYWORDS: Business Tourism; MICE (Meetings, Incentives, Conventions and Events); Environmental; Sustainability; Happiness; Trinidad; Sustainable Tourism Development Model

INTRODUCTION

Tourism is one of the fastest growing sectors in the world and it contributes to economic, socio-cultural and environmental benefits to many countries (WTTC 2009; WTO 2012; Cooper *et al* 2005; Swarbrooke and Horner 2001; and Ritchie and Crouch 2003). It brings economic value in the form of revenue generation, continuous foreign exchange earnings and is a means for diversifying the economy. Socio-culturally, tourism provides employment opportunities, it allows the local culture to gain wider acceptance and leads to cross cultural exchanges with other countries. The natural environment can also benefit from tourism in the form of green taxes, the induction of environmentally friendly practices by tourism facilities and beautification drives, which promote a level of aestheticism and happiness. Tourism represents a panacea to sustainable development for many countries. As such, different countries promote different forms of tourism products. Business Tourism or the MICE market (Meetings, Incentive, Conferences and Events) is one such niche market and it is on the front burner for some countries as it adds significant economic value to the tourism Gross Domestic Product (GDP). While this option is a viable one pursued as part of sustainable development strategy, key stakeholders have continuously lobbied that such development should not be pursued at the expense of the natural environment.The natural environment is of paramount importance in the business milieu today.

Companies and business tourism facilities are being encouraged to follow sound environmental practices when catering to the business tourism market, which would result in sustainable environmentally friendly business tourism. While this may be challenging to achieve, it can be done. New Zealand is a good example of a country that has developed sound environmental policies and practices built into its business tourism product. This has made the industry quite successful and it gives justification as to its use in this paper as a benchmark for assessing Trinidad's MICE market.This paper takes the following format. First, it examines the literature on the subject matter of business tourism and environmental sustainability; then it outlines what methodology was used to gather exploratory data; followed by the results and discussion section, which discusses the findings in light of the literature review. Finally, it proposes recommendations for the future concerning sustainable and environmentally friendly business tourism in Trinidad and concludes summarizing the key findings in this paper.

LITERATURE REVIEW

This section examines the various views and studies in the area of business tourism, sustainability, Trinidad's Meetings, Incentives, Conventions and Events (MICE) market and environmental strategies employed by New Zealand.

Business Tourism

According to Phelan *et al* (2009), business tourism goes beyond work purposes, sports tournaments, festivals, concerts etcetera. It incorporates all activities associated with the Meetings, Incentives, Conventions and Events (MICE) industry and it caters to the affluence and professional (Lawson 1982; Jafari 2000 and Swarbrooke and Horner 2001). Business tourism caters to those of a high-income bracket and according to the Business Tourism Partnership (2003), business tourism is at the high quality and high yield end of the tourism spectrum. Consequently, business travellers pay more for services (travel first class, stay at 5-star hotels, tip heavily) and indirectly pay higher taxes which can then be used to fund environmental or social programs thereby benefitting the host. In addition, they are more environmentally sensitive, willing to support and buy into environmentally conscious goods and services, promote Corporate Social Responsibility (CSR) initiatives and engage in greening projects. Generally, business tourism adds less to environmental degradation when compared to the leisure cruise market (Tourism Concern 2012). In this regard, business tourism is more sustainable than other tourism forms.

Sustainable Tourism

Sustainable tourism development builds upon the premise of sustainability. It takes into consideration the resource base that currently exists and the utilization of resources in a manner that the resource base of future generations are not impaired (Hall and Lew: 1999). Further, it promotes fairness and equality and aims to create win-win situations with the various stakeholders involved in the tourism process (Jurowski 2002). Sustainability is built on the premise that three pillars need to be satisfied (Maculay Institute 2006). These three pillars are the natural environment (eco-friendly), the economy (financial benefits), and socio-cultural benefits (create employment opportunities and preserve culture).

Business tourism can be sustainable and could bring real benefits if the three underlying pillars of sustainability work in harmony. However, the reality of the situation is that there are three pillars to satisfy with various stakeholders and behavioural reactions may not agree. Managers and stakeholders have their own interest (agency issues) and therefore it could be difficult to manage certain relationships (Elliott 1999; and Reichel and Haber 2005). One potential solution to the proper functioning of a business tourism niche is to bring the relevant stakeholders together so that they could develop a proper policy for the implementation and execution of business tourism. Tosun (2006) and Miller and Twining-Ward (2005), articulated that tourism planning has evolved and in the spirit of compromises, all stakeholders benefit (Dewhurst and Thomas: 2003).

Mair and Jago (2010) claimed that a number of stakeholders must take steps to reduce their environmental footprint. For example, in 2008, New Melbourne Convention and Exhibition Centre, was the first convention centre in the world to be awarded a six-star green star rating by the Green Building Council of Australia. The greening of business tourism practices are catching on quickly, in the form of changes to products, processes and policies. With regard to Trinidad, business tourism can be sustainable and there are prospects for future development (Tao and Wall: 2009). The infrastructure, geographical location, main target market access via dependable airlift, technology, people resources, environmental practices, aesthetics and sound banking systems all give due consideration and weight for the business tourism niche to fit into Trinidad's existing system.

<u>Trinidad's Mice Market</u>

The twin island Republic of Trinidad and Tobago is located approximately ten kilometres north of the South American continent. It gains significant wealth from oil and natural gas. The country has a population of 1.3 million people and is one of the most developed economies in this region. It is fast becoming the economic hub of the region with many business type hotels and facilities. The country boasts of natural attractions, historical sites, a diverse culture with various festivals (Carnival, Divali, Parang etc.), food and warm hospitable people. For example, the country has delicate eco-systems such as mangroves that are vibrant but also vulnerable to destruction; and is rich in biodiversity (habitat to numerous plant and animal species). Statistically, the tourism sector accounts for about 10.6% of the Gross Domestic Product (WTTC, 2009) and this figure is projected to rise given the government's current diversification developmental plan. This sector provides the best opportunities for inter-sector linkages to curb many problems such as revenue leakages via high spending on imports, and high food prices in society. In fact, tourism has been articulated as a strategy for diversification in the National Tourism Policy document of Trinidad and Tobago.

Locally, the government introduced a tax on the sales earned by companies, which goes to a green fund, and utilized for funding environmental efforts. Since going green has become a mantra and buzzword, many hotels have in fact gone green with their practices (Scott and Becken: 2010). The instillation of energy efficient light bulbs, sensor taps in the washrooms, the use of photovoltaic systems to heat water, limited use of plastics, encouraging the reusing of towels and other environmentally friendly practices have come on stream and are quite popular (Mair and Jago 2010). Some hotels are also promoting the conservation of resources given the general overuse of water resources in swimming pools, golf courses and personal use of water and energy by tourists.

Organizations in Trinidad & Tobago have also proactively responded by adopting voluntary initiatives to manage their environmental responsibilities and ensure that policies, procedures and practices conform to the entity's environmental targets and objectives. Specifically, multinational companies that have subsidiary operations in Trinidad, such as BP, Hilton and Hyatt are protecting their global customer image and value by ensuring that Corporate Social Responsibility initiatives and more in particular their environmental efforts are adopted by their subsidiaries.

The main challenge that Trinidad and Tobago faces as a country whose economy is heavily reliant on hydrocarbon exploitation is finding a means whereby to reduce emissions without harming favourable economic growth. Additionally, most companies in Trinidad and Tobago have not come to the realization that environmental accounting and the concept of "going green" makes good business sense. This may be explained by the hefty start-up investment required for which insufficient government support is given in terms of funding. Theoretically, according to Butler's model (1980), Trinidad displays symptoms of being at the Development stage of the Tourist Area Life Cycle. At the development stage, visitor numbers are climbing and the destination has to put measures, facilities and amenities in place to cater to the increased arrival of visitors. 'Development' is a phase and it is one that requires proper management (Cooper *et al* 2005). In this regard, development of tourism facilities should not be pursued in an ad hoc manner but due consideration should be given to the environment.

More so, business tourism has growth potential both in terms of diversification and in terms of economic impact on the GDP. The WTTC (2009) revealed that business tourism grew steadily from 2004 to 2008. The US$ in millions climbed from 159.0 in 2004 to 200.9 in the year 2008 and it is projected to increase further to 401.6 by the year 2019. While the business tourism market has growth potential and is a viable one, and environmental ills are increasing at a tremendous rate, the government has the capacity to put environmetal protection orders in place so as to promote sustainable development and foster happiness. New Zealand provides a good benchmark of environmentally conscious strategies to encourage sustainable business tourism. The country's strategies can be adopted wholly in some cases or customised to fit Trinidad's existing system and could lead to competitive advantage.

Environmental Strategies Employed By New Zealand

The environmental strategies employed by New Zealand, which have made it a competitive tourism destination, have been identified and listed in Table 1 (Source: New Zealand Sustainable Tourism Policy). These strategies include setting environmental indicators; putting supportive legislative framework; incorporating environment into its future strategy; and implementing and encouraging the use of more sustainable business reporting models.

Table 1: Identification of New Zealand Core Environmental Strategies

1.	Set environmental indicators to guide the tourism industry forward
2.	Put legislative framework to support the industry example. Waste Minimization Act 2008
3.	Make the environment a core part of future strategy
4.	Implement and encourage the use of more sustainable business reporting models
5.	Foster tighter networking relationship between all key stakeholder groups
6.	Set up a regional council pollution hotline where people can report pollution and environmental degradation
7.	Develop and adopt a sustainability policy for the business and review it regularly
8.	Develop an Action Plan, setting out ways to enhance sustainability performance; make someone responsible for each action and impose a deadline; review to ensure deadlines are met
9.	Integrate sustainability into existing management systems and processes (example. Build ethical recreation principles into operations manuals)-develop and implement induction and training processes that include sustainability as a core element to include in operational manuals
10.	Seek to become a carbon neutral certified business, reduce CO_2 emissions as much as possible, and offset those that remain (example. By funding native tree planting or energy efficient schemes to compensate for carbon released from vehicle and boat operations)-work with other tourism businesses, councils and community groups to implement a local "Trees for Travelers" sponsorship initiative
11.	Implement a formal client feedback process, and include sustainability performance as an area for comment; introduce client rewards for good ideas (example vouchers)
12.	Become Qualmark endorsed, by meeting the requirements for environmental accreditation
13.	Consult a business mentor, to identify more ways to operate efficiently (free up time), develop and grow the business.
14.	Communicate sustainability objectives to staff (example through awareness sessions, meetings), encourage suggestions, actively involve them, and reward achievements (build values into performance criteria for staff)
15.	Buy locally produced goods and services, sourced from medium, small and micro enterprises
16.	Establish a partnership with a local school, and work with local and regional partners to support the school and environmental education (education outside the classroom-mentoring students)
17.	Donate unused food to a food bank, food scraps to a pig farmer and donate old, partially used or unused products to local charities (example old linen, furniture, kitchenware, and office equipment that is still functional)
18.	Reduce contaminants by using natural products such as citrus, salt, vinegar and baking soda to clean surfaces, windows, drains and floors
19.	Educate guests as to how they can make a positive contribution to local biodiversity conservation efforts (example include information in compendium/notice boards on conservation efforts, volunteering and sponsorship opportunities)
20.	Implement team building days, volunteering on local conservation project (beach clean ups etc.)
21.	Review all products and services that you purchase, and advise your suppliers that you will give preference to products that meet social and environmental criteria (based on distance from origin, biodegradability, efficiency rating, recycled content, ability to be recycled etc.)
22.	Keep the community informed of initiatives and seek involvement and support

This table provides a listing of environmentally friendly strategies engaged by New Zealand.

METHODOLOGY

Qualitative research offers empirical information (Neuman 2006, Willis 2007, and Punch 2005), deep insight and richness of detail (Neuman 2006; Minichiello and Kottler 2009; Willis 2007; Hesse-Biber and Leavy 2006; Anfara and Mertz 2006; Punch 2005; and Outhwaite and Turner 2007). A qualitative research methodology was primarily selected to gather exploratory data in the area of business tourism and its environmental sustainability in Trinidad. This was necessary to get rich detail and probe the topic. A thematic analysis was then used for collating similar themes that emerged in the interview process. The data were collected from a structured questionnaire administered to seven key industry professionals who are located in the areas of: Ministry of Tourism (MOT); Tourism Development Company (TDC)/Convention Bureau; Bureau of Standards; the Environmental Management Authority (EMA); Trinidad Hotels Restaurants and Tourism Association (THRTA); Cascadia Hotel, a business hotel and a Tourism Consultant. This data was collected over a three month period (February-April 2011).

The formulation of the questionnaire entailed adapting relevant questions found in the literature (Cooper *et al* 2005; Edgell 1999; Duval 2004) with a view to addressing the environmental sustainability of business tourism in Trinidad. The questionnaire comprised of three sections with all open-ended questions. The first section asked questions pertaining to business tourism and its importance. The second section raised questions relating to the environmental sustainability of business tourism and the pros and cons of it. Finally, the third section solicited responses on issues pertaining to strategies and recommendations regarding the way forward for business tourism in Trinidad. The paper will also shed light on the various strategies employed by New Zealand and discuss whether these could be applied to the business tourism niche in Trinidad as a means of embracing environmental sustainability.

RESULTS AND DISCUSSIONS

This section of the paper presents responses from the seven interviewed respondents under three core themes: Business Tourism; Environmental sustainability of business tourism; and Future environmental strategy and recommendations.

Business Tourism

Consistent with the literature reviewed, all respondents agreed that increased technological advancements in air travel, economic growth, infrastructure, increased education and development of professional associations facilitated the growth of this niche market. However, one respondent stated that business travellers return to the destination as leisure or eco travellers because of environmental aesthetics and satisfaction. It was also determined that the increased propensity of business travel grew as a result of increased education, growth in bilingual skills, understanding of cultures, good knowledge of doing business, ease of travel, availability of facilities, and accessibility of company resources have all contributed to the rise of business travel.

Respondents reported that the business tourism niche was a significant market to make investment. The respondents claimed that some factors which make Trinidad a budding tourism destination are: geographic location; existing industries; infrastructure and flights; accommodation and facilities; environmental aesthetics; uniqueness; sound environmental practices; experience of hosting conferences; English speaking; existence of an environmental body (Environmental Management Authority) that upholds the preservation of the environment and economic pricing ($1 US = $ 6 TT).

Sustainability Of Business Tourism

The respondents stated that the environment is of paramount importance to any form of business and development. It is the responsibility of everyone including developers who design, build and engage in the supporting infrastructures. They are encouraged to follow established guidelines, practices, policies

and the regulatory framework so that these projects conform to environmental standards. At the same time, businesses have caught on to 'going green'. Many hotels have in fact adopted environmentally friendly practices as those outlined in the literature review. Respondents revealed that initiatives like e-tickets, using environmentally friendly products, energy efficient equipment in hotels, natural lighting, reusing of wastewater and managing of waste are great environmental efforts that can go a long way in preserving the environment for future generations. Interviewees also mentioned that rainwater can be utilised for landscaping and measures designed to reduce the amount of water in flushing hotel toilets.
By engaging in environmental good practices, business tourists are influence by these efforts and they follow the practice of locals in up keeping the environment. In most instances, they will return and encourage others to visit. Economically, this is good for a country.

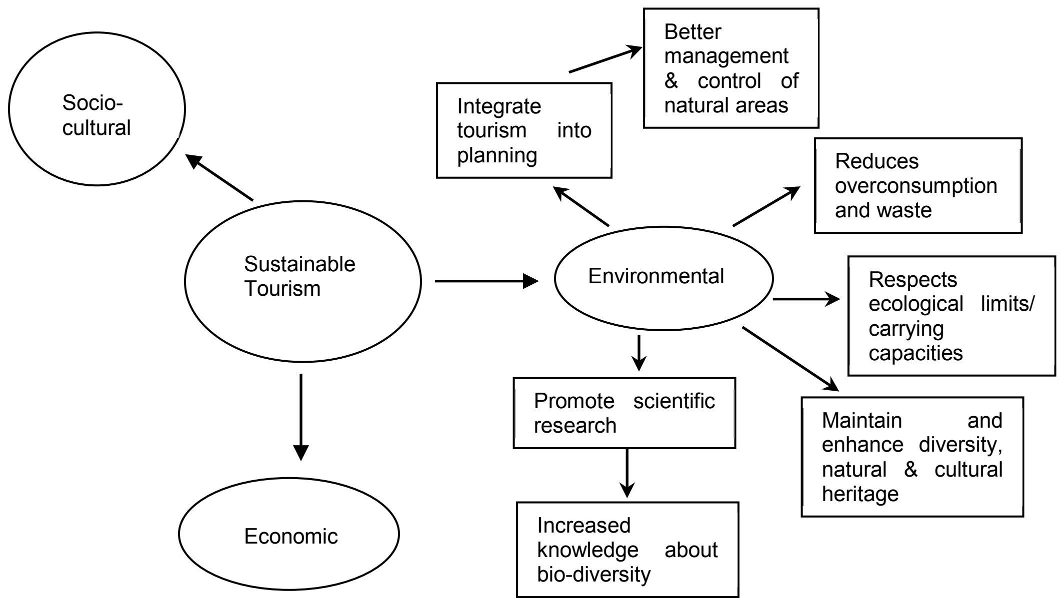
Foreign exchange is earn on a continuous basis and there is a positive spill-off effect, which contributes to job creation, entrepreneurial ventures and linkages with other sectors. The respondents also supported a strong regulatory framework to protect, preserve, care and maintain the natural environment. They claimed that a green fund tax and funding of green fund projects should continue and expand. They also recommended the passing and implementation of the Beverage Container Act, which adds value to the environment; create employment, and supports recycling initiatives. All respondents supported the view that this country generates a lot of carbon emissions and pollution, and they suggested that the government should market carbon credits as done in the United Kingdom. They also claimed that tax breaks could be an option to encourage green practices.

Future Environmental Strategy and Recommendations

Notwithstanding the existence of a Policy document (Trinidad and Tobago tourism policy) and a master plan (Vision 2020), all respondents were in favour that there should be environmental strategies for driving sustainable business tourism in Trinidad. In fact, the Government of Trinidad and Tobago has to adopt a policy to foster the development of economic activity in the country in an efficient, environmentally safe and sustainable manner. It was also suggested that there are skilled professionals who have the capacity and ability to inform this policy document. What is needed is more coordination among the key local stakeholders involved to move the environmental aspects of business tourism forward. The respondents shared the view that a strategy for an environmental public awareness drive is necessary. They claimed that this could be done through education and proper communication so that even the average person knows that there are benefits to be derived from environmental efforts when pursuing the diversification into business tourism. Communication has the tendency to shape behaviour and once people understand how they can benefit, they will buy-in and support such endeavours.
Respondents support the propensity of resource pooling as it affords cost effectiveness, diversification and promotes efficiency and effectiveness as it applies to environmental practices in business tourism. It was also mooted that benchmarking should be pursued vigorously to bring the tourism products in line with international green standards, practices, policies, legislations and regulations.

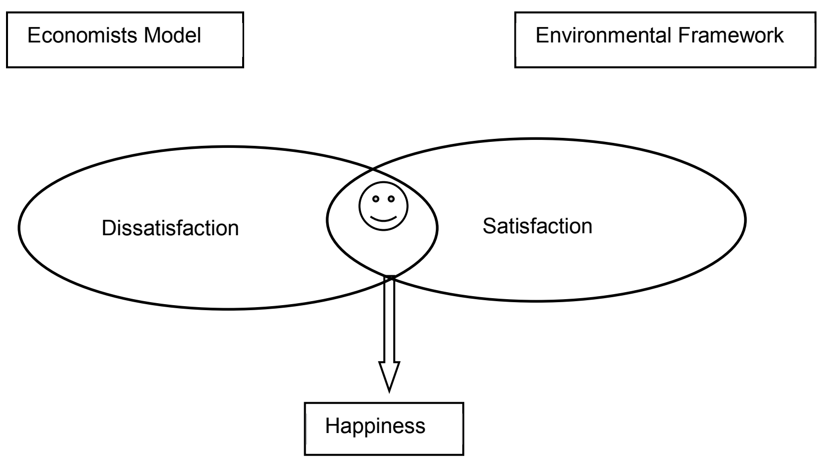
Given the very nature of business tourism and its fragility, the strategic plan should also focus on sustainability and sustainable tourism development, address the challenges of traffic congestion, engage in strategic marketing and reform the legislation so that players can comply. Overall, six respondents agreed that business tourism in Trinidad was environmentally sustainable and share the view that if business tourism is to be a high quality sustainable industry, all players need to play their respective role to ensure the viability of the MICE industry. In summary, this paper presents a framework that speaks to a sustainable development model and proposes an environmental happiness valuation model, which examines the satisfaction levels of all stakeholders. This model and the framework allow and display the importance of the environment, the economics and socio-cultural activities that influence sustainable tourism as the way forward. Figures 1 and 2 illustrate the model and the framework.

Figure 1: Pillars of Sustainable Tourism



This figure depicts the key components that influence sustainable tourism with particular emphasis on environmental sustainability.

Figure 2: A proposed environmental happiness valuation model



This figure displays a Venn diagram that illustrates the importance of the environment as it relates to Happiness.

It is felt that countries should now challenge the Gross Domestic Product (GDP) measurement metrics, that is the Economist's Model, for measuring the wealth of a country as against the environmental framework adopted by Bhutan which lists environmental protection as one of the four pillars of *happiness* as more important than GDP. In this regard, countries must change their measurement metrics and question the Economist's wealth valuation model. What is important is a country's *happiness,* and money (GDP) should not be the only yardstick to offer such a measurement. See the proposed *environmental happiness valuation* model and the contrasting views of the economists in Figure 2, which illustrates the relationship between the Economists' Model and the Environmental framework that measures the degree of satisfaction and dissatisfaction of these approaches. Note this figure depicts the contrasting views of the economists and environmentalists. Against this background, *happiness* should be the pillar all countries should foster for their citizens. Satisfaction leads to happiness, contentment and changes the quality of life. In short, any country that is seriously considering diversification into sustainable business tourism as the way forward, can apply this framework and the proposed environmental happiness valuation model.

Refining New Zealand's Environmental Strategies Employed In Its Business Tourism Sector To Accommodate Trinidad

New Zealand is a pioneer in terms of environmentalism and therefore their strategies can be moulded into bespoke strategies and embraced by Trinidad to gain a competitive edge in environmental sustainability. Trinidad's MICE market can adopt and implement the strategies identified in Table 1. Table 2 depicts which strategies to adopt wholly and which to customize. What would be required is proper marketing, communication, awareness building and in some cases regulations (both new and enforced) to get compliance and support to drive sustainable business tourism forward.

Table 2: Strategy Adoption / Customisation to fit Trinidad's Existing Environment

Adopt strategy wholly (Strategy #)	Customise it to fit Trinidad (Strategy #)
1	2
3 – 5	6
7 – 9	10
11	12
13 – 22	

This table depicts which strategies to adopt wholly and those that require customising to Trinidad's unique market.

Multi stakeholder involvement and support is crucial for many of the strategies to bear fruit and become successful. Apart from stakeholder involvement and support, community awareness and buy-in is needed so that there can be understanding in what the country is attempting to achieve. Understanding would lead to support and this would translate to individuals behaving with self-direction and a level of consciousness towards safe environmental practices. While the Environmental Management Authority has the regulations (EMA Act No. 3 of 2000) to guide individual, group and corporate behaviour towards operating in a more environmentally friendly manner, these regulations are seldom enforce. New Zealand has sound legislative framework and has the support of key stakeholders who police the environmental laws. Trinidad also needs to follow suit with regard to this.

While people can report environmental transgressions to the EMA, 24-hour hotline numbers provide an option since it may be vital in gathering data to enhance and support environmental preservation. Other initiatives include a tree planting/gardening initiative to get visitors and local schoolchildren involved in the activity; programs targeted at schools to award the students who can implement the best recycling product, for example make handicraft with recyclable products; challenging local engineers to build structures with reusable materials; and ensuring that local businesses comply with service standards.

CONCLUSION

This study revealed that Trinidad could gain immensely in the area of business tourism if it manages the delicate balance between tourism development and environmental sustainability. All respondents agreed that the diversification into business tourism was economically sustainable as it offers one of the best linkages to other sectors. Tourism represents one of many developmental activities that can be achieved in a responsible manner to prevent further loss to the environment as well as assist in reversing the environmental damage that has already occurred. The Government of Trinidad and Tobago has indicated its commitment to environmental preservation and upkeep in promoting sustainable development. Six out of the seven respondents supported the view that business tourism was environmentally sustainable in Trinidad. The challenges articulated are not insurmountable and with collaboration and key stakeholder engagement, there exist a potential for emerging economies to gain developed status. However, instead of attempting to re-invent ourselves into something which we are not, we should be focusing our diversification efforts in the area which we already have some competitive advantages.This study brought forth an exploratory understanding of where Trinidad's niche is currently in position and it highlights that business tourism can be environmentally sustainable representing a valuable market to invest. It also makes recommendations for the way forward by examining New Zealand's strategies and proposes an environmental happiness valuation model.

This exploratory research work has some limitations. For example, the sample size examined is small and one should be very careful when generalizing. Another limitation is that this study did not examine the economic and socio-cultural impact of business tourism. Cost and time were also constraints when this study was undertaken. Additionally, the results and findings were somewhat restricted given that the literature search found little empirical work on business tourism in Trinidad

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BIOGRAPHY

Narendra Ramgulam is a Research Assistant with the Department of Management Studies at the University of the West Indies. His research interests include Business Tourism, Sustainability studies, Anthropology, Globalization and Management in the 21st Century. He can be reached at the University of the West Indies, St. Augustine Campus, Trinidad. His email contact is: Narendra.Ramgulam@sta.uwi.edu.

Koshina Raghunandan-Mohammed is an Assistant Lecturer at the Department of Management Studies, The University of the West Indies (UWI). Prior to joining UWI, she gained a myriad of accounting, finance/investment and auditing experience in the credit union sector and the housing and education industries. She also has research interests in the following areas: Credit Unions, Risk Management Systems, SMEs, Financial Regulations and Environmental Sustainability. Her email contact is: Koshina.Mohammed@sta.uwi.edu.

Moolchand Raghunandan, prior to academia was a senior public servant, and is a Lecturer in Accounting at the University of the West Indies, St. Augustine Campus, Trinidad. He has published articles in Singapore, USA, ISER and the ICATT magazines. His email contact is: Moolchan.Raghunandan@sta.uwi.edu.

GOODWILL ACCOUNTING IN THE UNITED KINGDOM: THE EFFECT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Amer Qasim, Al Ain University of Science and Technology- Abu Dhabi
Ayman E. Haddad, American University of Kuwait- Kuwait
Naser M. AbuGhazaleh, Gulf University for Science and Technology (GUST)- Kuwait

ABSTRACT

The accounting treatment of goodwill has been the source of much debate and controversy amongst standard setters and financial report preparers in UK and many other countries. There have been great difficulties in the definition, measurement and subsequent accounting treatment for goodwill. Despite this, goodwill is a significant asset in many companies, whose existence and value are maintained by considerable annual expenditure. Accounting for goodwill changed in the UK in 2005 through the combined effects of the new International Accounting Standards, IFRS 3, Business Combinations, and IAS 36 Impairment of Assets. This paper critically examines, based on the accounting literature and professional standards, the change in accounting treatment for goodwill pursuant to international financial reporting standards (IFRSs) by reference to the UK accounting standards. It critically discusses and compares the former UK and new IFRS policies for goodwill accounting demonstrating the advantages of and arguments against the impairment-only approach to goodwill. It also highlights the sources of managerial discretion in testing goodwill for impairment and provides concluding remarks. Further studies are needed to examine the long-term effects of the impairment only approach to determine whether managers' opportunistic choices or their incentives to convey their privately held information drive the recognition of goodwill impairments. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill. It also provides a thorough review of the literature published on the accounting treatment for goodwill in the UK and provides avenues for future research.

JEL: M41

KEYWORDS: Goodwill Accounting, Impairment, International Accounting Standards, United Kingdom

INTRODUCTION

The controversy over accounting for goodwill has existed for many years. The issue of accounting treatment for goodwill has been seriously debated and has challenged financial report preparers and standard setters for decades. It has been the focus of extensive lobbying, principally by financial report preparers (Wines et al., 2007; Nobes, 1992; Bryer, 1995).

The term goodwill was initially used to mean value created by customer loyalty. One of the oldest definitions of goodwill is that of Lord Elton in 1810, given in a case at a bar in England more than one hundred ninety years ago, who defined goodwill to be "nothing more than the probability that the customers will resort to the old place." (cited in Owens, 1923, p. 282). However, accountants and others have criticized this definition because it connects goodwill with the idea of place (Owens, 1923). Later, this view was broadened to cover other intangibles capable of enabling a firm to generate profits in excess of the normal yield on other identifiable assets (Arnold et al., 1992). In short, goodwill was viewed as the present value of the future stream of superior earnings of the business to be acquired. Under this approach (the excess profits approach), earnings are determined and recorded as goodwill. However, goodwill, as conceptualized by this definition, is identified as an economic value, which is very difficult to measure since future earnings cannot be predicted with certainty (Seetharaman et al., 2004; Russel et al., 1989). The view of goodwill, which has been most influential in accounting thought, is the residuum approach that views goodwill as the excess of purchase price over and above the fair value assigned to the net assets acquired exclusive of goodwill (Arnold et al., 1992). Such goodwill will normally be positive; however, negative goodwill arises when the aggregate fair values of the net assets acquired exceed the acquisition cost. In these terms, while it may be generated internally, goodwill (by definition) is incapable of realization separately from the business as a whole and is only recognized in an accounting system when an entity has acquired another entity or part thereof, as goodwill cannot be purchased or sold as a separate item (Wines et al., 2007).

Certainly, three different approaches to accounting for goodwill have been proposed in the UK in the last 25 years: immediate write-off to equity reserves; capitalization with systematic amortization, and capitalization with impairment reviews (ASC, 1984; ASB, 1997; IASB, 2004a). The latest change to goodwill accounting was introduced in 2005 through the combined effects of the new International Accounting Standards, IFRS 3, *Business Combinations*, and IAS 36 *Impairment of Assets*.

While IFRS 3 prohibits the amortization of goodwill and forces managers to test it for impairment annually, irrespective of whether there is any indication that it may be impaired, it also provides the opportunity for accounting discretion by requiring managers to make several important accounting choices, of which the determination of the cash-generating units, the subsequent allocation of goodwill to these units, and the recoverable amount estimates of the units are the most important. Some managers may use this discretion to convey their private information; alternatively, others may use it opportunistically to distort the underlying economics of the firm by being selective with respect to the underlying choices they make when testing goodwill for impairment. Therefore, ex-ante, it is unclear how the impairment-only approach has affected the reporting of goodwill impairment losses, including the related managerial flexibility exercised in determining them. Given the significant amounts of goodwill in UK firms, the impact of the different goodwill accounting approaches on firms' financial statements is often not trivial. An indication of the role of purchased goodwill is provided by the ratio of purchased goodwill to the acquirer's total assets. AbuGhazaleh et al. (2011) report the mean value of this ratio to be 19%, reaching a maximum of 79 %. The sample of their study is drawn from the top 500 UK listed firms for the years 2005 and 2006, a period characterized by a high volume of mergers and acquisitions according to the British Office of National Statistics.

Motivated by the significance of goodwill in the UK company accounts and the inadequacy of critical research on the application of the new goodwill accounting requirements, this paper critically examines, based on the accounting literature and professional standards, the change in accounting treatment for goodwill pursuant to IFRSs by reference to the UK accounting standards. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill and is expected to extend our understanding of goodwill impairment accounting. Standard setters may also find this paper useful in their continuing deliberations on how best to structure and implement future standards that leave considerable room for managerial discretion and interpretation. The paper may also prove to be useful for researchers as it provides a thorough review of the literature published on the accounting treatment for goodwill in the UK and suggests area of potential future research. The issues raised in this paper may be of interest to any reporting regime based on IFRSs

The remainder of this paper is organized as follows. Section 2 briefly reviews the relevant prior literature. Section 3 critically discusses and compares the former UK and new IFRS policies for goodwill accounting. Sections 4 and 5 demonstrate the advantages of and arguments against the impairment-only approach to goodwill. Section 6 discusses the sources of managerial discretion in testing goodwill for impairment. Finally, Section 7 concludes.

LITERATURE REVIEW

Accounting for goodwill has long been a controversial area in the UK. The degree of controversy surrounding goodwill is presumably related to the quantities of goodwill that managers have to deal with (Nobes, 1992). Following the USA, the UK is considered the world's second largest market for corporate control. Higson (1998) reports that, as a proportion of the acquirer's net worth, the average goodwill in UK takeovers grew from negligible levels between 1976 and 1983, to an average of 60 % in 1988. There appear to have been two main reasons for the increase. The first was due to the increase in the market value of companies relative to the book value of their assets (Arnold et al., 1992, p. 3; Higson, 1998, p. 142). The second was the increasing proportion of companies taken over in the services sector, where a substantial part of the value consisted of intangible assets traditionally included in goodwill (Arnold et al., 1992, p. 3; Peasnell, 1996). In consequence, the accounting treatment for goodwill has become a major concern for financial report preparers and for accounting regulators. It has also been the focus of extensive lobbying, principally by financial report preparers (Nobes, 1992; Bryer, 1995).

Nobes (1992) identified several parties involved in the political process of standard setting in the UK, and concluded that different pressures resulted in a "cyclical standard setting" for goodwill in the 1980s. On the one hand, managers opposed standardization and income reductions, and on the other hand senior policy makers, government, press and international influences proposed it, which resulted in "dramatic swings in the content of documents on goodwill" issued by the UK standard setter (Nobes, 1992, p. 142).Bryer (1995, p. 283) develops another theory based on a Marxist analysis to explain goodwill accounting in the UK and argues that the immediate write-off of goodwill against equity reserves encouraged by SSAP 22 (ASC, 1984, 1989) was in the "collective interest of investors because it helped to hide from public view the fact that dividends were being paid from capital". In a study for the UK Accounting Standards Board (ASB), Arnold et al. (1992) conclude that, "although much has been written on the problem of accounting for goodwill during the past century, a solution remains elusive" (Arnold et al., 1992: p. vii).

Certainly, three different approaches to accounting for goodwill have been proposed in the UK in the last 25 years: immediate write-off to equity reserves; capitalization with systematic amortization, and capitalization with impairment reviews (ASC, 1984; ASB, 1997; IASB, 2004a). Given the significant amounts of goodwill in UK firms, the impact of these different approaches on firms' financial statements is often not trivial. The new requirements of IFRS 3 to review goodwill arising on acquisition for impairment as soon as possible after the acquisition date implies that any over-payments or under-performance have to be written-off immediately against income from operations, suggesting that the impairment approach may provide managers with incentives to use their accounting discretion to affect the timing and/or amount of such write-offs.

Motivated by the significance of goodwill in the UK company accounts and the inadequacy of critical research on the application of the new goodwill accounting requirements, this paper, based on the accounting literature and professional standards, critically discusses and compares the former UK and new IFRS policies for goodwill accounting demonstrating the advantages of and arguments against the impairment-only approach to goodwill. It also highlights the sources of managerial discretion in testing goodwill for impairment and provides concluding remarks

THE ACCOUNTING FOR GOODWILL IN THE UK

Superseded UK Accounting Treatment for Goodwill

By the beginning of the 1980s, practice in the UK was varied: some companies carried permanent goodwill; others amortized it, and most wrote goodwill off against reserves (Nobes, 1992).

The first official statement on accounting for goodwill in the UK was the publication in June 1980 of an Accounting Standards Committee Discussion Paper, *Accounting for Goodwill*. The Discussion Paper suggested that purchased goodwill should be systematically written off over its useful life, with a maximum of 40 years for amortization (ASC, 1980). Reactions to the Discussion Paper were mixed. Although there was some support for this conclusion from commentators, the majority of them believed that continued recognition of expenditure on purchased goodwill was of no value to the users of the accounts (Nobes, 1992).

This Discussion paper was followed by Exposure Draft 30, *Accounting for Goodwill*, issued in October 1982. ED 30 recommended that firms be allowed the option of either amortizing goodwill over its useful economic life (over up to twenty years), or writing it off against equity reserves in the year of acquisition. ED 30's theoretical justification for the immediate write off option was that purchased goodwill and non-purchased goodwill are of the same nature; hence, it is inconsistent to recognize the purchased goodwill in the financial statements and not to recognize the non-purchased goodwill (ASC, 1982, para 18). The public response to ED 30 indicated support for each of immediate write-off, amortization and a choice between them (Nobes, 1992).

The primary accounting standard for goodwill accounting in U.K was set out in Statement of Standard Accounting Practice No.22 (SSAP 22), *Accounting for Goodwill* issued by the ASC in December 1984 and revised in July 1989 (ASC, 1984, 1989). SSAP 22 permitted companies either to write off goodwill immediately against equity reserves or to capitalize and amortize it over its useful life. SSAP 22, although permitting either method, expressed a very strong preference for the immediate write off option (the preferred treatment) on the basis that it was consistent with the "accepted practice of not including non-purchased goodwill in accounts" (ASC, 1984, para 6). However, SSAP 22 remained silent on which reserves could be used for the purpose of writing off goodwill which resulted in a diversity of practice in this respect .A further change from ED 30 was that, in response to some criticism of the twenty-year amortization period, a time limit was not included in SSAP 22 (Nobes, 1992). The only significant practice to be outlawed was carrying goodwill as an asset without amortization.

Practice after SSAP 22 was almost universally to adopt its preferred method of immediate write off (Nobes, 1992; Arnold et al., 1992). Russell et al. (1989) reported that by 1986 the vast majority (98%) of large surviving UK firms were following the immediate write-off practice recommended by SSAP 22. The immediate write-off option was attractive to firms active in the market for corporate control since the firms' post acquisition reported profit figures were not adversely affected by the price paid for goodwill, thereby increasing the rate of return on capital and leading to the post acquisition results appearing more favourable (Peasnell, 1996). However, this accounting treatment soon led to some companies running against borrowing restrictions or stock exchange regulations due to the depletion of reserves. They were also concerned that their balance sheets were "weakened", making it less easy for them to take over and easier to be taken over (Arnold et al., 1992; Nobes, 1992; Russell et al., 1989). Furthermore, the UK practice of immediate write-off against equity reserves was out of step with that in the USA and most other European countries (Arnold et al., 1992).

From a theoretical point of view, immediately writing off goodwill against equity reserves is hard, if not impossible, to justify. It is simply a convenient way of disposing of an unwanted debit without reducing reported profit. It breaks the relation between reported profits and investment decisions, which managers are supposed to be accountable for (Arnold et al., 1992). Another unsatisfactory aspect of writing off goodwill against reserves is that it creates a possible bias against real investment in the economy (Arnold et al., 1992). Much of research and development expenditure has to be immediately charged against profits and investments in tangible fixed assets have to be depreciated. Writing off goodwill against reserves can give the impression that companies that grow through mergers and acquisitions are more profitable than other businesses, thereby raising the "buy-or-make decision" (Arnold et al., 1992, p. 59). In addition, this approach is against the accounting matching convention, which suggests that goodwill should be carried forward as an asset and matched against revenues of the periods expected to benefit from its use. However, the main advantages associated with this approach are that it avoids the difficult task of estimating the useful economic life of goodwill and is consistent with the general approach of not recognizing internally generated goodwill in the accounts (Lewis and Pendrill, 2004).

A controversial solution, which became increasingly popular in the late 1980s was to capitalize a major portion of purchased goodwill as brands and similar intangibles. Brands, unlike goodwill, were not the subject of an accounting standard and so did not have to be written off (Arnold et al., 1992). Consequently, it has been argued that SSAP 22 provided managers with accounting choices with respect to the initial recognition and subsequent accounting treatment for goodwill (Grinyer et al., 1991; Gore et al., 1998). Grinyer et al. (1991) report that the proportion of purchase price assigned to separable net assets and consequently to acquired goodwill was affected by contractual motivations such as gearing (leverage) and the availability of merger relief reserves. Similarly, Gore et al. (1998) report that contractual motivations such as debt covenants and management compensation schemes affected managers' reporting choices with respect to the two alternatives permitted by SSAP 22.

In response to criticism of SSAP 22, the ASC issued ED 47 (ASC, 1990a), *Accounting for Goodwill,* which required all purchased goodwill to be capitalized and systematically amortized over a period not to exceed 40 years, and outlawed the immediate write off against reserves. The major criticism was that the immediate write-off option obscured the rate of return on capital. The ASC also issued ED 52 (ASC, 1990b), *Accounting for Intangible Fixed Assets*, which would require brands and other similar intangibles to be amortized on the same basis as it proposed for goodwill in ED 47. While SSAP 22 attempted to achieve consistency between the accounting treatments of purchased and internally generated goodwill, ED 47 attempted to achieve consistency between the treatments of purchased goodwill and that of other purchased intangible and tangible fixed assets. ED 47 provoked confusion since UK firms had become rather fond of the protection that SSAP 22 had given to their earnings during the 1980s, a decade of major acquisition activity (Paterson, 2002). Responses to ED 47 from the corporate sector were almost wholly negative, and the proposal was never converted into an accounting standard (Nobes, 1992, Peasnell, 1996).

When the Accounting Standards Board (ASB) replaced the ASC in August 1990, the task of dealing with the goodwill problem was indeed a daunting one. Existing and proposed UK treatments were severely opposed by many, and experience from other countries such as USA suggested that international treatments were no less problematic (Kirkham and Arnold, 1992). In December 1993, the Accounting Standards Board issued a Discussion Paper, *Goodwill and Intangible Assets* (ASB, 1993). In this proposal it was stated that ASB would allow goodwill not to be charged to the profit and loss account through the annual amortization charges, but a write down would be required only where the goodwill had suffered impairment in value. The idea of impairment reviews first surfaced in an ASB-sponsored study (Arnold et al., 1992). The ASB has since devoted considerable effort to devising and pilot testing means of carrying out such impairment tests (Peasnell, 1996).

In June 1995 the ASB issued a Working Paper (WP) *Goodwill and Intangible Assets* (ASB, 1995). This working paper supported capitalization and amortization for goodwill and intangibles, except for those that are believed to have indefinitely long lives, in which case impairment tests only were to be used. The working paper also suggested that all balances for goodwill and intangibles, whether being amortized or not, would be subject to annual impairment tests and the balance sheet carrying value reduced via an immediate expense. After public hearings, this Working Paper was followed by a Financial Reporting Exposure Draft, FRED 12, *Goodwill and Intangible Assets*, in June 1996, and finally a new standard was issued in December 1997, FRS 10, *Goodwill and Intangible Assets*, both of which broadly followed the thinking of the 1995 working paper.

FRS 10 (ASB, 1997) was issued in December 1997 and seemed to have resolved most of the controversy surrounding goodwill at that time by addressing the issue of goodwill and other intangible assets in the same standard. FRS 10 required that purchased goodwill and intangible assets should be capitalized as assets and amortized under a rebuttable presumption that their useful economic lives do not exceed 20 years from the date of acquisition. However, there may be grounds for rebutting this presumption and regarding the useful economic life as greater than 20 years, or even indefinite, but only when the goodwill or intangible asset is expected to be capable of continued measurement. Where goodwill or intangibles are regarded as having indefinite useful economic lives, they should not be amortized. If goodwill is not amortized, or amortized over a period of more than 20 years, then an impairment review must be performed each year to ensure that the carrying value of the goodwill does not exceed its recoverable amount (the higher of net realizable value and value in use), in accordance with FRS 11 *Impairment of Fixed Assets and Goodwill* (ASB, 1998). In addition, an indication of impairment requires an impairment review without regard to the amortization period. FRS 10 permitted the reversal of a past goodwill impairment loss only if it can clearly be attributed to the unforeseen reversal of the external event that caused the recognition of the original impairment loss.

The way that UK firms applied the requirements of FRS 10 and FRS 11 was regarded as “slightly surprising, given their long-standing hostility to amortizing goodwill: most of them chose the amortization route in order to avoid the complexities of the full-blown impairment testing regime” (Paterson, 2002, p 102). Andrews (2006) reports that the majority of large UK firms in the 2004 financial year have selected 20 years as the finite useful economic life for goodwill and have amortized the asset over its finite life.

All European public companies have been required to use International Financial Reporting Standards (IFRS), including International Accounting Standards (IAS), to prepare their consolidated financial statements since 2005. Under the new international regulatory environment, UK public firms will have to prepare their financial statements in accordance with the International Standards and change the way they account for goodwill accordingly.

<u>IFRS 3 *Business Combinations* and IAS 36 *Impairment of Assets*</u>

In June 2001, the U.S FASB issued SFAS No.141, *Business Combinations* (FASB, 2001a), and SFAS No.142, *Goodwill and Other Intangible Assets* (FASB, 2001b), thereby replacing the existing requirements to amortize goodwill with an impairment testing approach. The IASB, seeking international convergence and global harmonization, followed the U.S FASB, and issued a new International Financial Reporting Standard (IFRS), namely IFRS No.3, *Business Combinations*, in 31 March 2004 (IASB, 2004a). The IASB revised IAS 36, *Impairment of Assets* (IASB, 2004b) on the same date. The requirements of these standards are quite similar to the U.S SFAS 141 and SFAS 142. IFRS 3 and IAS 36 (revised) replaced IAS 22, *Business Combinations* (IASC, 1983, 1998a) and IAS 36 (1998b), respectively.

Under IFRS 3, goodwill is no longer amortised but tested for impairment in accordance with IAS 36 (IASB, 2004b). According to IAS 36, goodwill acquired in a business combination should, from the acquisition date, be allocated to each of the acquirers' cash-generating-units, or groups of cash-generating-units that are expected to benefit from the synergies of the business combination. Each unit or group of units to which goodwill is allocated should represent the lowest level within the entity at which goodwill is monitored for internal management purposes; and it should not be larger than a segment based on either the entity's primary or secondary reporting format according to IAS 14 *Segment Reporting* (replaced by IFRS 8 *Operating Segments* on 30 November 2006). A cash-generating unit to which goodwill has been allocated shall be tested for impairment both annually and whenever there is an indication that the unit may be impaired. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit are not impaired. If, instead, the carrying amount of the unit exceeds its recoverable amount, the entity must recognise an impairment loss. The *recoverable amount* of an asset or a cash-generating unit is the higher of its *fair value less costs to sell* and its *value in use*.

The impairment loss is allocated firstly to the goodwill of the cash-generating unit (group of units) and then on a pro rata basis to the other assets within the unit (group of units), as long as it does not reduce any asset below the highest of its fair value less costs to sell, its value in use, and zero. The impairment loss is recognised immediately above the line in income from continued operations. Once recognised, IAS 36 prohibits the recognition of reversals of impairment losses for goodwill in subsequent periods.
According to IFRS 3, negative goodwill must be recognized immediately in the income statement as a gain. However, before concluding that negative goodwill has arisen, IFRS 3 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination (IASB, 2004a, para 56).

ADVANTAGES OF THE IMPAIRMENT APPROACH

The underlying logic for prohibiting the traditional amortization method is that straight-line amortization of goodwill over an arbitrary period does not reflect economic reality and thus does not provide useful information to the users of the accounts (Wines et al., 2007; IASB, 2004a; FASB, 2001b). It is usually possible for preparers to determine the economic life of depreciating assets, even if they cannot find a non-arbitrary way of allocating cost over that life; "with goodwill this is much more difficult, if not impossible" (Arnold et al., 1992, p. 60, Lewis and Pendrill, 2004).

In developing IFRS No. 3, the Board observed that the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortization depends on such predictions. As a result, the amount amortized in any given period can at best be described as an arbitrary estimate of the consumption of acquired goodwill during that period. Consequently, the Board argued that straight-line amortization of goodwill over an arbitrary period fails to provide useful information and concluded that a rigorous and operational impairment test would provide more useful information to the users of the financial statements (IASB, 2004a, BC 140, 142).

The amortization charge to goodwill has always been difficult to interpret. Many financial analysts used to ignore the goodwill amortization expense in their analysis of earnings per share (FASB, 2001b, B 77). Furthermore, many firms used to ignore the goodwill amortization expense in measuring operating performance for internal reporting purposes (FASB 2001b, B 90). Prior empirical studies examining the impact of the amortization expense on share prices provide little evidence that it is of significant value to users (Jennings et al., 2001; Moehrle et al., 2001). For example, Jennings et al. (2001) examine whether total earnings with goodwill amortization is more informative than total earnings before amortization. They find that earnings before goodwill amortization explain significantly more of the observed distribution of share prices than earnings after goodwill amortization, and that goodwill amortization adds "noise" making it harder for investors to use the earnings measure to predict future profitability. Similarly, Moehrle et al. (2001) find little evidence that goodwill amortization contains value relevant information and suggest that the amortization disclosures were not decision-useful, thereby, supporting the FASB's choice of impairment tests for goodwill instead of amortization.

Another argument against the amortization of goodwill provided by the FASB, is that amortization of goodwill is based on the assumption that goodwill is a wasting asset, and thus ignores the fact that part of what is recognized as goodwill may have an indefinite useful life that could last as long as the business is considered a going concern (FASB, 2001b, B 82).

Although testing goodwill for impairment was required in certain circumstances under the provisions of the superseded accounting standards, the impairment-only approach to goodwill requires an annual impairment test irrespective of whether there is any indication that goodwill may be impaired, and thus imposes a more stringent impairment requirement. One of the criticisms of the pre-impairment approach is that an absence of a specific impairment trigger gave firms too much discretion in timing the write-offs, which could be used by managers opportunistically to meet certain reporting objectives, resulting in impairments that do not adequately reflect the underlying economics of the firm (Henning et al., 2004).

For example, Hayn and Hughes (2006) report that a large number of pre-SFAS 142 goodwill write-offs appear to be taken only after a considerable period of time (three to four years) has elapsed after the economic deterioration of the firm, suggesting that managers were exercising their reporting discretion to delay goodwill write-offs before the implementation of SFAS 142 presumably to meet certain reporting objectives. Similarly, Henning et al. (2004) find that U.S firms delayed goodwill write-offs before the adoption of SFAS 142 since a disproportionately high percentage of firms with weak performance have recognized impairments upon adopting SFAS 142 and the transition period write-offs significantly exceeded predicted write-offs. In addition, prior U.S and UK studies examining goodwill write-offs (as a subset of asset-write-offs) prior to the adoption of the impairment-only standards report that these write-offs are void of economic substance and more likely to be associated with managers' reporting incentives than other classes of fixed assets (Francis et al., 1996, Kvaal, 2005). The requirement to test goodwill for impairment annually is likely to eliminate the discretion available to managers in deciding when to test goodwill for impairment which may in turn result in the recognition of more timely impairments that better reflect the true underlying economics of the firm.

Furthermore, a number of studies examining the information content of goodwill impairments recorded subsequent to the adoption SFAS 142 report negative correlations between these impairments and stock returns and suggest that the impairment-only approach to goodwill has improved the quality of reported information on goodwill by allowing managers to reliably convey their private future-cash-flow information to markets (e.g., Hirschey and Richardson, 2003; Bens and Heltzer, 2004; Chen et al., 2004; Li et al., 2006; Zang, 2008; Lapointe-Antunes et al., 2009). These studies conclude that SFAS 142 is "net beneficial" consistent with the standard setters' objectives in developing the new impairment standards. Similarly, a number of studies examining manager's use of discretion in determining goodwill impairments following the adoption of the impairment-only approach in USA, Canada and the UK fail to find evidence that managers are opportunistically using their accounting discretion to distort the underlying economics of the firms (Lapointe-Antunes et al., 2008; Godfrey and Koh, 2009; Jarva, 2009; AbuGhazaleh et al., 2011).

ARGUMENTS AGAINST THE IMPAIRMENT-ONLY APPROACH

Although the impairment-only approach was issued to improve the subsequent accounting for goodwill and provide users of the accounts with value relevant information that more closely reflects the underlying economics of goodwill, this approach has been largely criticized and opposed by academics, practitioners and dissenting IASB members. The issues raised focus primarily on the managerial discretion inherent in the process of testing goodwill for impairment, and on the resulting blending of acquired goodwill and internally generated goodwill. For example, Watts (2003) criticized the impairment approach based on the subjective and unverifiable fair value estimates used in testing goodwill for impairment. Watts (2003, p. 217) argues that "SFAS 142 may be an error in judgment by the FASB…Assessing impairment requires valuation of future cash flows. Because those future cash flows are unlikely to be verifiable and contractible, they, and valuation based on them, are likely to be manipulated". Similarly, Massoud and Raiborn (2003, p. 30) note that the managerial discretion and judgement afforded by the impairment approach may lower the quality of earnings figures.

Based on the implications of the contracting theory of accounting (Watts and Zimmerman, 1986), there is a large possibility that managers may exploit the discretion afforded by the impairment standard opportunistically to transfer wealth and make themselves better off at the expense of other contracting parties, resulting in goodwill impairments that do not adequately reflect the true underlying economics of the firm. Massoud and Raiborn (2003, p. 30) argue that managers may selectively "opt to manage earnings through a cursory, rather than intensive review of goodwill asset impairment". For example managers may decide to record large goodwill impairments when operations are at downturn following the "big bath" behavior. Alternatively, they may take goodwill impairment losses during periods in which actual earnings are higher than expected following the income smoothing behavior.

The respondents to Exposure Draft 3, *Business Combinations* (the exposure draft that preceded IFRS 3) who expressed a clear view on the issue of accounting for goodwill generally opposed the impairment-only approach and supported the amortization approach with impairment tests only when there is an indication that the goodwill might be impaired. They supported this approach by arguing that acquired goodwill is a wasting asset that is consumed over time and replaced, to a greater or lesser extent, with internally generated goodwill and that the acquired goodwill therefore must be amortized to ensure that no internally generated goodwill is capitalized as an asset in its place, consistently with the general requirements of not recognizing internally generated goodwill in the accounts (IASB, 2004a, BC 139).

Another argument raised by the respondents for amortizing goodwill consistent with the matching convention was that goodwill should be allocated to achieve a proper allocation of its cost to future operations, consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives. A final argument was that the useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which goodwill diminishes be known. However, systematic amortization over an albeit arbitrary period provides an appropriate balance between conceptual soundness and operationality at an acceptable cost; the respondents concluded that amortization is the only practical solution to an intractable problem (IASB, 2004a, BC 139).

However, the IASB makes no reference in its basis for conclusions to whether this was the view taken by the preparer or non-preparer group. Preparers and non- preparers are expected to differ in their lobbying positions regarding how to account for goodwill based on their own self interest (Watts and Zimmerman, 1978). Preparers (managers) are more likely to lobby for the impairment-only approach since it allows them greater scope and discretion in deciding when to recognize an impairment loss. Ramanna (2008) provides evidence consistent with the idea that the FASB issued SFAS 142 in response to political pressure by firms (preparers) over its proposal to abolish the pooling of interests method with potential for opportunism. Ramanna suggests that firms' (preparers') lobbying positions for SFAS 142 depend on their ability to opportunistically manipulate goodwill accounting discretion Prior UK evidence also reveals that preparers have generally opposed goodwill standards that required systematic income reductions (Nobes, 1992).

On the other hand, non-prepares (e.g., auditing firms and standard setters) are more likely to oppose the impairment-only approach and support amortization because it is less complex, more objective, and can easily be audited. For example, two IASB members who dissented from the issue of IFRS 3 argued that

"IFRS 3 is putting its faith in a potentially unreliable impairment test that inevitably cannot separate out subsequent internally generated goodwill and has other weaknesses that require attention" (IASB, 2004a, DO 12). The dissenting members concluded that the costs of goodwill impairment tests are likely to be high and the benefits of such tests may be diminished by their potential unreliability (IASB, 2004a, DO 12). Similarly, Paterson (2002) argues that the impairment approach may have the trappings of science, but it is of doubtful reliability, as well as being onerous and difficult to perform.

Finally, in a US study examining managers' use of discretion in determining goodwill impairments, Ramanna and Watts (2009) report that non-impairment of goodwill is increasing in firm characteristics predicted to be associated with greater managerial discretion and provide evidence that this discretion is being used by managers opportunistically to distort the underlying economics of the firm.

SOURCES OF MANAGERIAL DISCRETION IN TESTING GOODWILL FOR IMPAIRMENT

Goodwill impairment is a result of the deteriorating economic performance of the acquired business. The acquired business is rarely operated as a distinct subsidiary within the firm, making its performance difficult to track (Hayn and Hughes, 2006). The acquired business is usually integrated into the operations of the acquiring firm; carried as part of an existing operating segment; or split among several internal units, making the process of evaluating goodwill for impairment more difficult and subjective (Hayn and Hughes, 2006). Furthermore, neither IFRS 3 nor IAS 36 provides measurable indicators of goodwill impairment. However, IAS 36 provides external and internal signs that may reduce the recoverable amount of a cash-generating unit or asset below its carrying amount. Examples of external indications include negative changes in technology, markets, economy, or laws, increases in market interest rates, and book value of equity more than its market capitalization. Examples of internal indications include plans to discontinue or restructure the operations to which an asset or cash-generating unit belongs and worse economic performance than expected (IASB, 2004b, para. 12). The U.S SFAS 142 adds that unanticipated competition and a loss of key personnel may also be possible indications of goodwill impairment (FASB, 2001b, para. 28).

Despite the standard setters' contention that the impairment-only approach will improve the quality of accounting for goodwill by forcing managers to test it for impairment annually, the impairment criteria provided by the standards are drafted in such a way that leave significant room for managerial discretion, interpretation, judgement and bias (Massoud and Raiborn, 2003, p. 28).

The first instance of managerial discretion is the managerial flexibility with respect to the definition of cash- generating units. Goodwill is tested for impairment at the cash-generating unit level. A cash-generating unit is defined by IAS 36 as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets. According to IAS 36, cash-generating units to which goodwill is allocated shall represent the lowest level within the firm at which goodwill is monitored for internal purposes; and not be larger than a segment based on either the firm's primary or secondary reporting format, thus implying that it does not have to be a specific subsidiary, division, branch or component. The lack of specificity in the definition of a cash-generating unit provides managers with significant flexibility in the identification of cash-generating units for impairment purposes. Thus, provided they have incentives to maximize or minimize future impairment losses, managers could "pick-and-choose" units in a way that best serves their own incentives (Massoud and Raiborn, 2003, p. 28). The larger and more numerous the cash-generating units, the greater is management's flexibility in allocating goodwill and hence determining future goodwill impairment losses as will be discussed shortly.

The second instance of managerial discretion is related to the allocation of goodwill to cash-generating units. For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash generating units, or groups of cash generating units, that are expected to benefit from the synergies of the business combination. Absent a specific joint cost allocation model, allocating goodwill to cash-generating units can be arbitrary and difficult to implement (Watts, 2003). In addition, goodwill is frequently the result of synergies between distinct operating units, and precisely identifying the source of such synergies and allocating them across cash-generating-units is "non-trivial" (Bens and Heltzer, 2004). The process of allocating goodwill to cash-generating units is expected to have an impact on the likelihood of an impairment loss being recognized (Beatty and Weber, 2006).

On the one hand, firms that have their goodwill allocated to more than one cash-generating unit are expected to carry out more impairment tests and thus may report higher amounts of goodwill impairment losses because an existing loss in one unit cannot be netted against an increase in another unit (Schneider, 2001). This may motivate managers to cut down the number of cash-generating units to minimize the impairment outcome (Schneider, 2001). On the other hand, firms with numerous cash-generating units may have greater flexibility in determining future impairment losses (either overstating or understating impairments). For example, managers willing to write-off a large amount of goodwill -"take a bath"- may have incentives to allocate the greater part of goodwill to cash-generating units that are expected to decrease in value (units with low growth options). In contrast, managers willing to delay or have little goodwill impairments may have incentives to allocate the greater part of goodwill to cash generating units that are expected to increase in value (units with high growth options) and hence lower the probability of recognizing goodwill impairment losses.

The third instance of managerial discretion is the assessment of the recoverable amounts of cash-generating units that contain goodwill. The recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. If no deep and liquid market exists for an asset or cash-generating unit to determine its fair value less costs to sell, the IASB considered that value in use may be used as its recoverable amount. However, because cash-generating units to which goodwill relates typically do not have active markets and hence no readily available fair values, managers primarily use the value in use technique to assess their recoverable amounts. In order to determine the value in use of a cash-generating unit, managers must use their judgement to forecast future cash flows and choose an appropriate discount rate that is appropriate to the risks of those particular units. Assessing the value in use has always been "as much an art as a science" and different experts can arrive at different valuations depending on the underlying assumptions employed about discount rates and future cash flows (Wayman, 2002). Therefore, it has been argued that managers might be able to calculate both impairment and non-impairment of goodwill in the same period, depending on their selection of underlying assumptions (Massoud and Raiborn, 2003, p. 29). In the case of goodwill impairment testing, the use of managerial discretion is further facilitated by the fact that no financial information is publicly available at the cash-generating unit level unless each unit is a public firm itself, which is rarely the case (Hayn and Hughes, 2006; Lapointe-Antunes et al., 2008). Therefore, it is difficult for outsiders to make an external assessment of the recoverable values of cash-generating units, to which goodwill has been allocated, providing managers with more flexibility and discretion in testing goodwill for impairment.

CONCLUSION

This paper critically examines the change in accounting treatment for goodwill pursuant to international financial reporting standards (IFRSs) by reference to the UK accounting standards. It discusses and compares the former UK and new IFRS policies for goodwill, demonstrating the advantages of and the arguments against the new impairment-only approach to goodwill.

The accounting treatment for goodwill has been the source of much debate amongst standard setters and financial report preparers. There have been great difficulties in the definition, measurement and the subsequent accounting treatment for goodwill. Goodwill is a unique intangible asset in that it does not generate cash flows independently of other assets and is not separable from the company as a whole. It is measured as a residual amount, being the excess of the purchase price over the acquirer's interest in the fair value of the identifiable net assets acquired.

Accounting for goodwill has always been a controversial issue in the UK. The first attempt by the accounting standard setter in UK, SSAP 22, raised more problems than it resolved. The two different accounting treatments it permitted were "conceptually inconsistent" (Hussey and Ong, 2000, p. 37). The debate in the late 1990's in UK resulted in the amortization of goodwill instead of the immediate write-off to reserves. With the transition to international reporting standards in UK from 2005, all UK public firms listed in the main market had to change the way they account for purchased goodwill and account for it using IFRS No. 3, *Business Combinations.* IFRS 3 prohibits the amortization of acquired goodwill and instead requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with IAS 36 *Impairment of Assets*.

The impairment-only approach was issued with the intent of improving the information content of goodwill and reducing the managerial flexibility afforded by the former trigger-based standards. However, this approach has been criticized by academics, practitioners, and dissenting IASB members on the grounds of the managerial discretion inherent in the process of testing goodwill for impairment. While IFRS 3 forces managers to perform annual goodwill impairment tests, it also provides the opportunity for accounting discretion by requiring managers to make several important accounting choices, of which the determination of the cash-generating units, the subsequent allocation of goodwill to these units, and the recoverable amount estimates of the units are the most important. These accounting choices provide managers with significant discretion and flexibility in determining the existence, timing, and amount of goodwill impairment losses.

Thus, if managers have incentives to overstate, understate, or simply not recognize an impairment loss, they can be selective with respect to the underlying choices they make when testing goodwill for impairment. On the one hand, as predicted by the standard setters, managers may use this accounting discretion efficiently to convey their private information and expectations regarding the true value of the firm, resulting in impairments that better reflect the firm's underlying economics; alternatively, managers may opportunistically exploit this unverifiable accounting discretion to extract rents from other contracting parties, resulting in impairments that are less reflective of the firm's underlying economics. Therefore, ex-ante, it is unclear how the impairment-only approach has affected the reporting of goodwill impairment losses, including the related managerial flexibility exercised in determining them.

Prior empirical studies examining managers' use of discretion in determining goodwill impairment losses following the adoption of SFAS 142, Section 3062 and IFRS 3 in USA, Canada and the UK respectively, provide inconclusive evidence as to whether managers are using the discretion afforded by the impairment approach opportunistically or to convey their private information on future cash flows. As time passes and more data become available future research will be able to examine the long-term effects of the impairment-only approach to goodwill and determine whether the conclusions of these studies hold over time. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill that may be useful for any regime reporting under IFRSs. It also provides a thorough review of the literature published on the accounting treatment for goodwill in the UK.

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BIOGRAPHY

Amer Qasim: Al Ain University of Science and Technology, Abu Dhabi- United Arab Emirates. He received his PhD in Accounting from Aberdeen University, UK. His research interests are in the areas of Internet Financial Reporting, Voluntary Disclosure, Investor Relations and Value Relevance of Accounting Information. Email: qasemamer@hotmail.com

Ayman E. Haddad: The American University of Kuwait- Kuwait. He received his PhD in Accounting from the University of East Anglia, UK. His research interests are in the areas of Disclosure of Accounting Information, Corporate Governance, Value Relevance, Stock Market Liquidity, Dividend Policy, Cost of Capital and International Financial Reporting Standards. Email: Ahaddad@auk.edu.kw

Naser M. AbuGhazaleh, corresponding author: Gulf University for Science and Technology (GUST)-Kuwait. He received his PhD in Accounting from Aberdeen University, UK. His research interests are in the area of Financial Reporting, Corporate Governance, Earnings management, Goodwill Accounting and Internet Financial Reporting. Email: Abughazaleh.N@gust.edu.kw

RETIREMENT PLANNING: NEW FACULTY ORIENTATION

William P. Dukes, Texas Tech University

CASE DESCRIPTION

Most Colleges/Universities require all full-time employs to be a member of a Retirement System, whether the choice is "defined benefit" or "defined contribution". When the distinction is made clear, probably 85 to 90 percent of employees select the "defined contribution" approach over the more strict requirements of the "defined benefit" approach. The term used at Wendell University is "Optional Retirement Program" (ORP) that requires each employee to contribute 6.65 percent of the salary while Wendell University contributes 6.0 percent. This 12.65 percent of the employee's salary is sent to the employee's choice of a "Carrier" for investment.

At the request of the Dean of the College of Business of Wendell University, Jack Pettyjohn, an investment advisor of Lovell & Co., makes a presentation every year as part of the new faculty orientation. Jack has a license to sell securities along with a license to provide investment advice. He has a preference for investment advice rather than selling securities. Consequently he receives calls frequently to make presentations to Corporations sponsoring 401(k) plans to their employees. Wendell University's retirement plan is a 403(b), which is similar to the corporate 401(k) plan. Jack enjoys making presentations to University Faculty more than to the attendees of the corporate 401(k) plans.

Jack considers Wendell's Provost a friend, having had finance classes with the Provost when he was a faculty member in the College of Business. The Provost is also a contact man when other departments or Colleges at Wendell request similar presentations. At each presentation Jack believes that he was being challenged. He did not want to be considered to be a salesman with so many teachers looking forward to his presentation. He knew the audience was expecting tangible and useful data on retirement plans.

The case is appropriate for all academic units that have retirement plans sponsored by the State or private schools. In addition however, the case would be appropriate for all businesses or organizations that sponsor retirement programs for their employees. Time to prepare for the presentation would be no more than three hours and for another hour for discussion.

JEL: G-110

KEYWORDS: Retirement Plan; Mutual Fund: Expenses; and Performance.

CASE INFORMATION

The Investment Company Institute (ICI) publishes an Investment Company Fact Book annually that contains much current information pertaining to Mutual Funds. A mutual fund is an Investment Company that starts by selling shares to investors to gather assets which are used to invest in various types of securities, depending on the objectives of the fund. Morningstar follows and has data on 25,256 mutual funds that covers objectives about as broad as one's imagination.

Portfolio theory indicates that an investor should have about twenty or more different securities to satisfy the need for diversification, but most small investors have from four to ten different securities. An illustration to show that an investor can receive professional management and diversification by the purchase of one share of an index fund such as Vanguard 500 Index., which was priced at $98.93 in a recent Wall Street Journal. Vanguard 500 Index replicates the S&P 500 by holding all 500 stocks in the index and holds them in the same proportion in each sector/industry as held in the S&P 500 Index. By holding at least one share or more of Vanguard's 500 Index, one is assured of a return the same as the market, as represented by the S&P 500 Index.

Table 1: Range of Investment Companies

The ICI shows investment companies by type as follows:		
Mutual Funds	$9,601 billion	8,889
Closed-End Funds	188 billion	646
ETF's	531 billion	743 (and growing)
UIT's	29 billion	5,984

Figure 1 lists the various types of Investment Companies, the total dollar amount for each type and the number tracked by the Investment Company Institute (ITI). The "market" determines the size and the number of each type of fund. Obviously, open-end mutual funds are the most desired, and investors show it with their money (like trillions of dollars).

The UIT is a Unit Investment Trust which has a varied size portfolio put together by a Trustee. For the most part the securities are tax exempt. Shares of the portfolio trust are sold to investors at net asset value (NAV) plus a minimal commission. The assumption is that the shares are "redeemable", but in all cases, the trust closes when the bonds mature.

ETF's are Exchange Traded Funds that are portfolios of securities designed to track a sector or an index. For most portfolios they are not managed, but could be. The ETF package is assembled by brokers and sold to investors much like they were individual stocks and the market prices the package as though they were stocks. Since the ETF is traded like a stock, the brokerage commission is similar to individual securities.

The Closed-end Fund is put together much like the UIT and ETF in that the capital structure is fixed and does not change. The portfolio could be stocks, bonds or municipal securities. The portfolio of securities is actively managed and is traded much like the ETF. The Funds are traded like stocks by brokers handling the security to include a brokerage commission like other stocks in the secondary market. Municipal bonds make up more than half of the closed-end funds. One big difference with closed-end funds is that the shares will likely trade at a discount. Market activity determines the price like any stock.
Open-end Mutual Funds are the primary part of the discussion, and can include equity (stock) funds, bond funds, hybrid (quite popular) or money market funds. There are many complexes of funds, frequently called families of funds, such as Fidelity, Vanguard, T. Rowe Price and American Funds, to name a few. The largest is Fidelity, followed by Vanguard. Some families of funds are true no-load funds such as Vanguard, Fidelity and T. Rowe Price. American and Evergreen are all load funds. A few may be classified as no-load, but they handle some funds in the load category, still preferring to be called no-load.

Mutual Funds that are "open-end" can be load, low-load, deferred load, and no-load funds. The distinction is quite important. Load funds are sold to those who go to a broker, banker, insurance company, financial planner or others who charge a commission (load) to the investor. As an example, Evergreen Omega A charges a front load of 5.75%, and a 0.25% 12b-1 fee; Omega B charges a deferred fee of 5% and a 1% 12b-1 fee; Omega C charges a 1% deferred load and a 1% 12b-1 fee; and Omega R charges a 0.5% 12b-1 fee.

Care must be used in evaluating a "Deferred Load", sometimes called a "back-end" load. One must read the fine print to determine the time length of the deferred load. Some charge a deferred load only if the fund is redeemed within one or perhaps two years after purchase, and none thereafter. For many, this deferred load serves to discourage short term holding by those *trading* in funds rather than *investing* in funds. The ICI Fact Book has additional information that defines "other load" with the statement:

"Primarily includes retirement share classes known as R shares". By telephone, the impact was explained as zero minimum purchase, no charge going in and no charge coming out. The Morningstar sheet shows the only charge (other than the Expense Ratio) as a 0.50% 12b-1 fee, which of course is added to the Expense Ratio.

The name "open-end" mutual fund is very meaningful in that the "open-end" carries the meaning "that it stands ready to redeem (buy back) its shares from investors." Marketability is guaranteed as long as the fund is continuing to function. Mutual Funds are unique in another way in that the number of shares outstanding is not limited. This unlimited number of shares for a mutual fund permits all shareholders the option of "dollar cost averaging". Dollar cost averaging is accomplished by arranging to purchase a set dollar amount of shares on a continuing basis. If the price of the fund increases, a set amount of dollars purchases fewer shares, and when the price declines, the shareholder purchases a larger number of shares. Therefore, the average cost of shares will be less due to the purchasing of more shares at a lower price when the price declines.

The minimum initial investment varies greatly from American Fund at $250 (with additional purchases at $50), to Vanguard Health Care, PRIMECAP, and Capital Opportunity at $25,000 each. Most other Vanguard funds are $3000 for initial purchase.

The "net asset value" (NAV) is the value of a share of a mutual fund which is market controlled and determined by the value of the fund at the close of the market each day, which is usually 4 PM Eastern time. The purchase and sale (redemption) of a share is determined by the close price whether the request to buy or sell is made at 9:30 AM Eastern time as the market opens, or just before the close in the afternoon. The purchasing price will be NAV for no-load funds, and for front-load funds the price will be NAV plus the load charge, called the "public offering price".

If a mutual fund has a NAV of $20 a share and a front-end sales charge of 8%, the public offering price (POP) is $20 plus $1.74 for the load. This is determined by dividing the NAV by (1 minus the sales charge) ($20/.92). One can find the sales load if the NAV is divided by the public offering price. In this example, $20/$21.74 = 0.91996 or 92%. This means that the NAV is 92% of the offering price, or that the investor paid an 8% front-end load. Investors could more accurately determine the true load charge by dividing the load charge ($1.74) by the NAV ($20) to get 8.7% for the front-end sales charge (rather than 8% advertised by the fund).

The NAV is calculated at the close each day. Any increase in the price of the fund is called an unrealized gain, because the mutual fund did not sell at the higher price to realize the gain. Likewise, decreases in the price of the mutual fund are unrealized losses.

The vertical listing tells the capitalizing choices, while the horizontal indicates the nature of the type of activity, whether the choice is growth, value or blend. The "style box", shown above, divides mutual funds into nine categories, based on size and methodology. Fund choices are divided into large, medium and small depending on whether they invest in large-capitalized, medium-capitalized or small-capitalized stocks. In addition, the funds are divided by whether they invest in stocks that are categorized as Value, Blend or Growth oriented securities. As an investor, one could select a mutual fund in each category of large growth, large value, medium-blend and small-growth, or any other combination of the nine categories.

Table 2: What Is Your Investment Style?

	Value	Blend	Growth
Large		C	
Mid			A B
Small			

In Table 2 the nine categories provide desirable information. As an example, assume that an investor believes that the health care sector is very good and useful. The investor checks Fidelity and finds "Fidelity Select Medical Equipment & Systems" categorized as "Mid Cap Growth" so the investor puts an A in the corresponding style box. The investor studies T. Rowe Price and chooses "T. Rowe Price Health Sciences Mid Cap Growth", so a B is placed in the appropriate style box. A search of Vanguard yields the selection of "Vanguard Health Care" listed as Large Blend, so we enter a C in Large Cap stock with a style of Value/Blend/Growth in the Large Cap Blend style. In most situations, the risk would be expected to be high, but by combining these three health sector stocks, the risk is reduced. Upon further scrutiny, we learn that the correlation of the stocks is quite low between these funds. Therefore, a portfolio of these three funds received an average of about 24,000 growth compared to S&P's 15,000, according to Morningstar.

How Risky Is The Fund?

Morningstar provides for risk in a number of ways. The normal presentation for risk is: above average, average, below-average, and very infrequently low (e.g. Vanguard Health Care). In addition, "volatility measurements" are Standard Deviations, with 3, 5, and 10 year measurements given. Further, the Sharpe Ratio (a measurement of risk-adjusted performance) is provided for 3, 5, and 10 years. Additional risk indicators are given in "Bear Market Decile Rank" and "Modern Portfolio Theory" statistics are given such as "beta".

How Has the Fund Performed?

Most Morningstar Returns are shown as Low, Below Average, Average, and Above Average, but a few funds are given a return of High (e.g. Vanguard Capital Opportunity and Vanguard PRIMECAP). A second presentation of "Trailing Total Return" gives Year to Date, 12 months, 3, 5, 10 and 15 year returns and a percent rank in each time period. The return from Inception is provided for those interested in longer term returns. The third presentation is given in graphic form for easy reading. It is a 10 year graph for those funds in existence that long, or a much shorter time period is shown by the graph indicating the growth of $10,000, with S&P 500 and others in the same category. The S&P 500 is shown as 10k, with others in the same category as about 18k and for Vanguard Health Care as about 25k.

How Much Does It Cost?

When one begins to compare mutual funds, one should notice that funds that follow the same or similar investment objectives tend to invest in similar securities. This leads us to a very important part of mutual fund investing – RETURNS. Mutual fund returns are determined by two factors in general: the returns of the securities in which the mutual funds invest and the various expenses and load charges of the mutual funds. Since there are more than 25,000 mutual funds and less than 9,000 stocks, many funds will hold the same and/or similar stocks. Consequently, the major differences will be the load charged and the expenses of the operation. Another factor frequently overlooked is the tax-consequence of the fund, which is part of the expense for investors. As a side note, unrealized gain means that the value is higher, but the "realized gain" is a capital gain on which the investor must pay a tax. After the tax is paid the value of the investment is less than before the capital gain was realized.

Earlier, an illustration was given to show that a multiple class of funds covers the range from no-load, to front-end load, to back-end load, and on occasion there is "no-load" but with a 12b-1 fee. Most load fees are a onetime charge, but with the 12b-1 fee it is continuous, with an annual charge every year. In addition, more than 90 percent of all front-end load funds also charge a 12b-1 fee. In most cases the "back-end" load is a "contingent deferred load" (CDSL), which means that the deferred load may be cancelled if the fund is held a certain length of time. As an example, a fund could have a 5 year CDSL and if the investor held the fund for the full 5 years, the load is cancelled. In some cases if the fund is held for 1 year the CDSL is reduced to 4 years for a 5 year CDSL.

The 12b-1 fee is classified as a "distribution" fee. Portfolio managers lobbied to get the fee to help them sell their funds. The maximum 12b-1 fee is 1% annually. This fee has been used in many different ways not intended by the Security Exchange Commission (SEC), such as using it as collateral for a bank loan. The investor must be very careful when looking for a "no-load" fund. The Investment Company Institute (ICI) has supported use of the term "no-load" for mutual funds with a 12b-1 fee of no more than 0.25% per year. This support has resulted in the creation of a new term--"true no-load". There is no compelling reason to buy a load fund unless you are receiving investment advice from an advisor who sells load funds and you are not aware that there are mutual funds with no-load, no 12b-1 fee and lower expense ratios.

Earlier, an illustration was given for Evergreen Omega funds, with class A shares having a front-end load, B shares having the investor pay for services with a 12b-1 fee and a deferred sales load, and C shares are designated as level-load (no front-end load) but typically pay a full 1% 12b-1 fee and a CDSL. In addition to the A, B, and C class shares, some families of funds have additional designations, such as American Funds, some of which have an F1 and F2 category. The F means free of sales charges, but there can be an "advisory fee" paid by the investor. We have been told that typically the expense ratio is higher for F shares when compared to class A shares (the fee is an expense related charge). These charges are in addition to the regular operating expenses.

The inability to control ones tax liability is a major disadvantage of many mutual funds. When the fund sells at a profit, the investor incurs a taxable gain. Many retirement plans are tax-deferred. This means that one is required to pay taxes when money is withdrawn from a tax-deferred account, which means that the tax is deferred, perhaps many decades. In most retirement accounts, withdrawal is not permitted until after age 59½. Early withdrawals are subject to large penalties. For the most part, retirement accounts are tax-efficient; therefore, it is desirable to place tax-inefficient funds in retirement accounts given an opportunity to do so. Given a choice, funds with higher turnover ratios would fit in retirement accounts better than funds with smaller turnover ratios, but neither may be available when the choice is made for the retirement account. With some retirement plan carriers, such as TIAA-CREF, the individual plan holder is permitted to make switches from one type of investment to another. Some faculty members have been known to switch out of an equity plan to a fixed income plan when a recession is expected, then at a later date, switch back to equities. In most situations, "buy and hold" provides a better return for the investor.

Turnover is the ratio of the portfolio that is replaced annually. A high turnover means that the investor is realizing gains and losses constantly, which limits the investor's ability to manage tax obligations. Turnover causes three types of cost: the explicit cost of tax liability, the loss from the spread, and transactions cost. For a mutual fund, purchases and sales (transaction costs) will normally run into millions of dollars annually. To illustrate the spread impact, assume the bid-ask spread is 0.5% and the turnover rate is 60%, the reduction in the fund's total return is 0.3%, in addition to the tax impact and the transaction cost.

An additional tax is charged directly to the investor for distributions made by the mutual fund, whether the distribution is from income (dividend) or capital gains. A large number of investors have the dividend and capital gain reinvested in additional shares, but the tax is still paid.

Because taxes are such an important part of investing, some investors tend to focus on the tax consequences of funds. Brokerage houses have been known to sell growth funds as tax-advantaged funds as a way to get more customers. Growth funds tend to hold stocks through the entire upward ride and delay selling until the price begins to decline. During the uphill swing, gains are not realized. When the declines begin, sales are made to lock in the gains. This is a sales strategy accepted by brokerage houses. Under the situation given, gains are taken or they will become losses.

In summary, investors can face tax consequences from holding mutual funds, 1) when an investor sells fund shares for more than they cost, 2) when a fund distributes interest and/or dividends received from investments, and 3) when the fund sells securities for more than cost and distributes the capital gains.

MORNINGSTAR

Morningstar is the main independent analysis and provider of service of mutual funds. Morningstar provides much information on the web site Morningstar.com, as well as the service on a commercial basis. We will compare four Morningstar funds using the "Snapshot" report. The first is Vanguard's 500 Index Fund. It is a proxy for (and replicates) the S&P 500 very closely. It can be used for comparison purposes when other funds are analyzed. The other three mutual funds are all good performers within their family of funds. Fidelity Blue Chip Growth is one of the better funds of Fidelity, the largest mutual fund family. The third is T. Rowe Price Mid-Cap Growth Fund. The fourth is Vanguard Capital Opportunity, a large cap growth fund.

The first page of the report provides basic information: a snapshot of the firm. On the mid-page left side is a section containing a graph and data for the most recent four year performance of Fidelity Blue Chip Growth. The graph and data table shows fund return, the comparison with the S&P 500, and category which is Large Growth. For the year 2009 the total return is 44.96%, which is 9.28% better than its category and 18.5 % better than the 500 index. The last line of the table shows the asset size of $11,107 million. For T. Rowe Price Mid-Cap Growth the total return is 45.46%, 6.35% above its category which is Mid-Cap Growth, and 18.99% better than the 500 index, with Net Assets at $14,664 million. Performance of Capital Opportunity is 48.91% total return, which beats its category by 13.23%, and the 500 Index by 22.45% points, with Net Assets at $4,184 million. Note that all four mutual funds are compared to the S&P 500 Index. Vanguards 500 Index was 0.02 points below the S&P 500. It follows the S&P 500 very closely.

Most investors would not desire to have all funds follow the S&P 500. For diversification purposes it would be wise to have some funds follow other indexes, such as Russell 2000. At the top right corner of the Snapshot sheet, Net Assets size is given. Note that Vanguard's 500 Index (at $46,774 million) is considerably larger than the other three funds we are comparing, such as Fidelity Blue Chip (at $10,545 million), T. Rowe Price Mid-Cap (at $15,636 million), and Capital Opportunity (at $3,792 million). The Vanguard 500 Index Fund is very widely held and considered a main fund in the Mutual Fund field.

Morningstar is recognized very widely for its star ratings. Vanguard 500 Index Fund has 3 stars, primarily because it replicates the S&P 500 as the market indicator. Just by coincidence the Fidelity Blue Chip, T. Rowe Price Mid-Cap, and Vanguard Capital Opportunity funds all have 4 stars. The stars provide a ranking of the funds. It considers both the performance and the risk of the fund as it ranks versus all other funds. The top 10% are given 5 stars, the next 22.5% are given 4 stars, the middle 35% earn 3 stars, the following 22.5% are given 2 stars and the lowest 10% earn 1 star. Of the three funds with 4 stars each, one must break the tie with other evidence. For instance, Vanguard's Capital Opportunity Fund has been assigned 5 stars in the "Rating and Risk" section for the 10 year activity. The Rating and Risk section is located on the right side of the Snapshot sheet, adjacent to the performance graph. This section shows Morningstar Ratings Overall, at 3 years, 5 years and 10 years. The second line shows the number of funds

Rated for each four time periods (Overall, 3 years, 5 years and 10 years.) The third line designates Morningstar Risk, which for Capital Opportunity is above average for each of the four time periods. The fourth line of the Rating and Risk section provides a level of rating for Morningstar Return, which, for Capital Opportunity, is for Overall High, 3 years Above Average, 5 year High, and 10 year High. Below the 3, 5, and 10 year indicators, the Standard Deviation and Mean Returns are shown for each time period. The star ratings give consideration to loads and expenses. The star rating is an overall rating that gives no consideration to the fund's category.

In addition, on the first page (Snapshot) there is a brief indication of fees that includes Front-end Load, Deferred Load, 12b-1 fee and the Expense Ratio. It should be noted that of the four funds being reviewed, the lowest expense ratio is Vanguard's 500 Index at 0.18. This should surprise no one because all S&P proxies have low expense ratios since their managements are following the activity of the S&P 500, which is minimal. However, the expense ratios of the other funds are Fidelity Blue Chip (0.76%), T. Rowe Price Mid-Cap (0.83%) and Vanguard Capital Opportunity (0.50%). The generalized average given that the average expense ratio for all funds is about 1.5%. Page 4 of the Morningstar report shows a graph of the expenses of each fund in comparison with the expense ratio of the "category" for that fund. Vanguard Funds relative expense compared to their category are generally much smaller than that of the category. Vanguard's Capital Opportunity Fund had expenses of 0.5 (year 2009) in comparison to 1.27 for the category average. This relationship is common for Vanguard Funds.

We could have included a load fund for comparison purposes, such as Evergreen or American. The average expense ratio for eight of Evergreen's funds appears as 1.31%, along with a front-end load of 5.75% and a 0.25% 12b-1 fee. To illustrate that load funds should not be an investor's choice, we have made comparisons of about 8 funds of Evergreen, American and Vanguard funds. This comparison is shown below:

Table 3: Averages for Three Families of Funds

Item	Evergreen	American	Vanguard
Load	5.75%	4.45%	0
12b-1	0.25	0.245	0
Exp. Ratio	1.31	0.90	0.335
Star Rate	2.875	3.09	4
Turnover	73.6	34	21.5

Table 3 shows that with a given dollar amount invested in each of the three families of mutual funds, Evergreen and American result in a net less investment due to the entry load of 5.75% and a 4.45% relative entry cost. The cost of doing business is considerably higher with Evergreen and American, with the expense ratio being multiple times higher than with Vanguard. These two expenses result in a much lower return for the investor. The good news is that those expenses can be avoided by the selecting of no-load mutual funds.

Next to the Fee data on the Snapshot sheet on the left side is a brief section on Management. One of the more important items is the "tenure" of the manager. For Vanguard Capital Opportunity Fund the management has been in place for 11.6 years. The success of the fund has been recognized during the tenure of the management team. Likewise for the T .Rowe Price Mid-Cap Growth Fund, the manager has been in place for 18 years, during which time success has been recognized.

The style box confirms the category Morningstar states as being the type of investment securities used in the portfolio. By coincidence, all three funds selected for analysis are in the growth category, two using large category securities and the other using mid-cap securities. In each category management believes they can identify and purchase securities which are underpriced and which they believe the market will identify and elevate for good profit by the funds. Growth firms in particular are those that have expectations of earnings growth and/or expansion that exceed the market in certain categories. Two examples should clarify the possibilities. Teva Pharmaceuticals is the largest "generic" producer in the world and the market is recognizing the potential. The other illustration is the specialty medical devices, prostheses, and reconstruction implants, the need for which is growing and recognized by Stryker and Zimmer Holdings. Other than the increasing need for replacements caused by wars, the techniques developed for knee and hip replacements are providing medical help for an increasing number of elderly and those in unfortunate accidents.

The next section of the report is more detailed information on the returns of a mutual fund. An historical perspective can be gained by examining the chart and the three funds at the same time. The first pass covers the years 2008, 2009 and 2010. The year 2008 was a bad year so expectation should be limited. In 2008 all three funds were in the negative category, but the poorest of the three was the T. Rowe Price Mid-Cap. The year 2009 was a much better year for the market and all three came back strongly but Capital Opportunity was about 3.5 percentage points above the other two. Up to this point 2010 is another bad year at the halfway mark, and Price Mid-Cap was the only one of three with a positive return, with the market down quite a bit. In the Trailing Total Return section, all three were showing good returns for the last 12 Months, all with returns greater than 50%, and the return since Inception (all more than 10 years) ranged from 10.4% for Fidelity Blue Chip to 13.4% for the Price Mid-Cap at 13.4%. Returns shown beyond YTD and 12 months are 3, 5, and 10 years annualized. The only negative return for the 3, 5 and 10 years annualized was Fidelity Blue Chip at -2.1% for the 10 years annualized. This 4 + year comparison with category and S&P 500, along with annualized data out 10 years, should give an investor a basis for selection. At this point in time the overall best of the three would be T. Rowe Price Mid-Cap, and in a bull market Vanguard Capital Opportunity looks the best.

Further down in the return section is the tax analysis. Previously, this important information had a cost attached to it. The chart shows the before-tax return and after-tax return. Then it shows the fund's percentage rank in its category. Vanguard is in the top 14% for tax efficiency over the last decade in the large value category.

The tax rates used are the current and highest income and capital gains tax rates. It would be nice if these rates did not increase. State and local taxes are ignored. The tax-cost ratio is another measure. It is calculated as the after-tax return divided by the before-tax return. The closer the ratio is to 100% the better the fund. If it is below 60%, the fund incurs excessive taxes. The above tax figures assume the investor will hold the fund rather than sell. If an investor is planning on selling the fund, the potential capital gains exposure is important. It tells us the percentage of the stocks in the portfolio incurring capital gains if sold.

A high capital gains exposure is not bad. If a fund follows a "buy and hold" strategy, it will have large amounts of unrealized capital gains. A small number may mean that the fund is buying and selling quickly (churning), increasing the investors current tax liability.

The next section provides a further breakdown of the risk of the fund. It gives the standard deviation and mean of the fund for 3 years, 5 years and 10 years, along with the bear market decile rank. Recall that the standard deviation is a risk measure. The bear market decile rank examines how well the fund would perform during a recession. Funds must have been in existence for at least five years to be included in the ranking. Funds with a ranking near 1 should perform well in a recession. Mutual funds with a 5 year bear market rank close to 10 are not likely to perform well in a recession. The T. Rowe Price Mid-Cap Growth and Fidelity Blue Chip Funds both have a rating of 4, and Vanguard Capital Opportunity Fund has a rating of 6. For diversification purposes, an investor should want to hold funds that have both high ranks (do well in expansions) and low ranks (do well in recessions).

Morningstar also calculates the "beta" of each fund using the S&P 500 and the best fit index. All three funds reviewed here have betas ranging from 1.07 to 1.11, and R-square ranging from 88.64 to 94.53. It is desirable to see that Morningstar calculates Alpha (a performance measure) range from 7.06 to 8.6, with the T. Rowe Price Mid-Cap Growth Fund holding the higher rating. All three funds provide good ratings on betas, R-square, and Alpha, although the betas above 1 indicate an aggressive position.

The section just below "Ratings and Risk" provides the top investment holdings in the portfolio. Fidelity Blue Chip, as an example, shows the name of the stock, Sector Year to Date returns, and the percentage the stock is of the portfolio. The top stock is Apple, Inc., Hardware sector, with a Year to Date return of 27.65%, and is 5.87% of the portfolio. The equity Investment Style has a Market Cap of $31,814 million. Vanguard 500 Index has no choice on category because it tracks the S&P 500.

The Equity Style Breakdown covers mainly large cap stocks, but can vary from Growth, Value, or Blend. Value measures include the Price/Earnings ratio at 15.45, Price to Book at 2.51, Price to sales 1.25, Price to cash flow 6.03 and dividend yield at 1.58%. The market cap breakdown is Giant (47.57%), Large (32.34%), Medium (17.02%), Small (2.7%) and Micro (0.37%). The T. Rowe Price Mid-Cap Fund has mostly medium cap at 78.73%, with Large at 16.88% and Small Cap at 4.4%. This is a bit more of what the investor should expect.

Morningstar presents further information in the Asset Allocation section. The Vanguard 500 Index has 0.11% cash (indicating little need), and US stocks at 99.89%. Most other funds would have a broader allocation, such as T. Rowe Price Mid-Cap with 5.09% cash (indicating small need), 90.14% US stocks and 4.77% non-US stocks. Vanguard's Capital Opportunity has the allocation of 3.59% cash, 84.05% US Stocks and 12.36% non-US stocks.

The top 20 holdings are presented for consideration. Capital Opportunity has six Health Care securities in the top 20, whereas Fidelity Blue Chip has two, as does T. Rowe Price Mid-Cap, but with no duplication. It is not surprising that the names of the Mid-Cap stocks might not be as recognized as for the other Large Cap Growth funds, but very little duplication of stocks occurs in the three funds. At first glance there are no duplications, which is probably unexpected. There are duplications between Vanguard 500 Index and the other three funds in this top 20 for each fund. The total number of stocks held varies greatly, even in the three for comparison. The 500 Index (at 504) tops the others, which are Fidelity Blue Chip (211), Capital Opportunity (112), and T. Rowe Price Mid-Cap (at 139). The turnover varies considerably with Vanguard 500 Index and Vanguard Capital Opportunity at 12, T. Rowe Price Mid-Cap at 31, and Fidelity Blue Chip at 134. The greater the turnover, the greater the tax burden on the investor.

The yield of Mutual Funds is the dividend/price, and is normally not very high. The yield for Vanguard 500 Index is 2%. For Capital Opportunity, the 12 month yield is 0.34%, 0.46% for Fidelity Blue Chip and 0.00% for T. Rowe Price Mid-Cap.

SECTOR FUNDS

Before leaving Morningstar it should be noted that we have not recognized the fact that most families of funds have "sector" funds. All three of the families we have highlighted have sector funds. With no exception, all three had high quality sector funds with ratings of 4 stars or higher. The sector fund will have the great majority of its stocks held in the field of the sector concerned. Rather than having 100% of stocks in the same sector, some will have "consumer service" or "consumer goods" in small amounts.

In comparing the three good funds we have highlighted with the six sector funds from the same families of funds, looking at the average risk for 5 year returns, the two groups were close. However, the range of standard deviations was much lower (by as much as four percentage points), and higher by about the same amount. The return since inception for the two groups was about the same. The graphic growth of 10k that Morningstar presents was much higher for sector funds than those of the sample we used. The 10 year standard deviations were considerably lower for the sector funds, and the average of the returns for the sector funds were better by at least a multiple of three. The expense ratios were about the same.

The overall assessment of the sector funds used was considerably better, even considering the higher volatility of the sector funds. Consequently the sector funds should be considered by investors if they are patient and are looking for better long term investments.

One should recognize that higher cost and higher expenses are not desirable. Before the market went sour and all financial instruments were functioning properly, mutual funds were performing in a very acceptable manner. We hope that the words "load," "commission," "12b-1 fee," and "Class A, B, and C" are all load driven mutual funds that investors should avoid. The comparison in Table 4 below between No-Load, No 12b-1 fee, and Load and 12b-1 fee mutual funds should help your understanding:

Table 4: U.S. Domestic Stock Funds

	No-Load & No 12b-1 Fee	Load and 12b-1 Fee
Number of funds	3721	7806
Expense Ratio	1.22%	2.14%
Sharpe Ratio	1.48	1.19
Fund Average size	$749.18 million	$213.5 million
Total Assets	$2,787,699 million	$1,667,205 million
Morningstar rate	3.25 (stars)	2.59
Performance		
12 Months	7.33%	2.96%
5 Years	3.27%	2.68%
10 Years	9.22%	6.52%
Front-Load	0	1.29%
Deferred Load	0	2.05%
12b-1 Fee	0	0.76%
Total 12b-1 cost	0	$12,670.76 million

Table 4 illustrates that the Load/12b-1 funds cost 4.9% ($166.82 million) MORE to manage 67.2% FEWER assets. The No-Load/No 12b-1 assets are $2,787.699 million and the Load/12b-1 assets are much smaller at $1,667,295 million. The 12b-1 fee of $12.671 billion is a "DEAD WEIGHT" cost to shareholders for a single year. What did the shareholders of load funds get for their $12.671 billion? INFERIOR RETURNS. Mutual Funds without loads and 12b-1 fees have fewer expenses, higher Sharpe ratios, much larger asset bases, and produce a higher return.

QUESTIONS FOR CONSIDERATION

1. Why should I buy a no-load mutual fund?

2. Why should I use mutual funds in my retirement plan?

3. Is it possible I can invest in a bond mutual fund? What is the difference?

4. Should I buy my mutual funds from an experienced broker?

5. Distinguish between a large cap value fund and a mid-cap growth fund.

6. I have been told that I can buy a Class B mutual fund that does not have a front-end charge. What is the difference between a no-load fund and a Class B no front load fund?

7. What is dollar cost averaging?

8. What is an "open end" mutual fund and how does it differ from a closed end mutual fund?

9. What does Morningstar have to offer to an investor wanting to buy mutual funds?

10. Someone said that a high expense ratio fund would have better management. Explain the issue.

11. What is a sector fund? Is there any problem with a sector fund?

12. In light of this information, what advice do you have for the new faculty member?

RETIREMENT PLANNING: NEW FACULTY ORIENTATION

TEACHING NOTES

William P. Dukes, Texas Tech University

CASE DESCRIPTION

Most Colleges/Universities require all full-time employs to be a member of a Retirement System, whether the choice is "defined benefit" or "defined contribution". When the distinction is made clear, probably 85 to 90 percent of employees select the "defined contribution" approach over the more strict requirements of the "defined benefit" approach. The term used at Wendell University is "Optional Retirement Program" (ORP) that requires each employee to contribute 6.65 percent of the salary while Wendell University contributes 6.0 percent. This 12.65 percent of the employee's salary is sent to the employee's choice of a "Carrier" for investment.

At the request of the Dean of the College of Business of Wendell University, Jack Pettyjohn, an investment advisor of Lovell & Co., makes a presentation every year as part of the new faculty orientation. Jack has a license to sell securities along with a license to provide investment advice. He has a preference for investment advice rather than selling securities. Consequently he receives calls frequently to make presentations to Corporations sponsoring 401(k) plans to their employees. Wendell University's retirement plan is a 403(b), which is similar to the corporate 401(k) plan. Jack enjoys making presentations to University Faculty more than to the attendees of the corporate 401(k) plans.

Jack considers Wendell's Provost a friend, having had finance classes with the Provost when he was a faculty member in the College of Business. The Provost is also a contact man when other departments or Colleges at Wendell request similar presentations. At each presentation Jack believes that he was being challenged. He did not want to be considered to be a salesman with so many teachers looking forward to his presentation. He knew the audience was expecting tangible and useful data on retirement plans.

The case is appropriate for all academic units that have retirement plans sponsored by the State or private schools. In addition however, the case would be appropriate for all businesses or organizations that sponsor retirement programs for their employees. Time to prepare for the presentation would be no more than three hours and for another hour for discussion.

SOLUTIONS

Questions 1: Why should I buy a no-load mutual fund?

Solution1: Reference page 11 in the case. The Table of U.S. Domestic Stock Funds: No load benefits;

Expense ratio better: 1.22%	VS	2.14%
Sharpe Ratio better;	1.48	1.19
Morningstar rating;	3.25 Stars	2.59
Performance better		
12 Months	7.35%	2.96%
5 Year	3.27%	2.68%
10 Year	9.22%	6.52%
Load	0	1.29%
Deferred Load	0	2.05%
12b-1 fee	0	.76% (1% Maximum)
Cost of 12b-1	0	$12.67 billion (Dead weight)

Question 2: Why should I use mutual funds for my retirement plan?

Solutions 2: Many choices: equity, bond or hybrid, shares can be redeemed – excellent marketability (see Page 1 and Page 3). Receive professional management (see Page 1), Good diversification (see Page 1), Funds redeemable on request (see Page 3) and Wide range of choices: 25,256 funds (see Page 1),

Question 3: Is it possible that I can invest in a bond mutual fund? What is the difference?

Solution 3: Of the 25,256 funds, many are bond funds. Most "families" of funds is of the bond type. Morningstar covers a large number of bond funds. In addition, many closed-end funds are bond funds, municipal funds in particular. TIAA-CREF also has bond funds. The TIAA are all bond funds. Basically UIT (Unit Investment Trust) are bond funds. Page 2.

Question 4: Should I buy my mutual funds from an experienced broker?

Solution 4: Brokerage Houses sell only load funds to investors who do not know better. All funds sold by brokers have unnecessary charges such as front-end load (commissions), and more than 90% of all front-end loads also have 12b-1 fee charges, higher expense ratios or some combination of the charges that are not needed. Most load funds have lower returns because of these charges. Experienced investors buy no-load funds.

Question 5: Distinguish between a large cap value fund and a mid-cap growth fund.

Solution 5: Reference page 4. "What is your Investment Style" explains that "large cap" means that most of the stocks in the fund are large capitalization types of securities. "Large" means more than $8 billion market cap (Market cap = price of stock multiplied by the number of shares outstanding). The term "value" means that the stocks are considered undervalued, higher dividend payers, lower price earnings ratios, and the expectation is that the stocks will have little if any growth in prices. The "mid-cap" means stocks in the portfolio are mostly of a size between $1 billion and $8 billion market caps. "Growth" means that expectations are that the prices and usually earnings per share will grow.

Question 6: I have been told that I can buy a Class B mutual fund that does not have a front-end charge. What is the difference between a no-load fund and a Class B no-front load fund?

Solution 6: The difference is large. A true no-load has no charge other than the operating expense ratio. The class B normally does not have a front-end load, but to replace that there is generally a deferred load, and in most cases the 12b-1 fee is the maximum of 1%. A 1% 12b-1 fee is far worse than a front-end load. Refer to page 3.

Question 7: What is "dollar cost average"?

Solution 7: Refer to page 3. Dollar cost averaging is a planned process in which an investor arranges to purchase a set dollar amount of funds by arranging to send the certain amount of money to a mutual fund at a predetermined time period, such as $x every month on the first day of the month. When the price of the fund goes up, fewer shares are purchased and when the price of the fund declines more shares are purchased with set amount of money. In so doing the average cost of all shares is less by purchasing more shares at the lower price.

Question 8: What is an "open-end" mutual fund and how does it differ from a closed-end fund?

Solution 8: Refer to page 3. The "open-end" has the meaning that the mutual fund agrees to redeem (buy back) the shares so desired by the investor in any amount. Therefore, marketability is assured. As long as the fund is functioning. It also means that the number of shares outstanding is not limited.

Question 9: What does Morningstar have to offer to an investor wanting to buy mutual funds?

Solution 9: Refer to pages 6 to 11. Morningstar provides everything one needs to make a decision about purchasing funds. The Snapshot alone covers all of the details most investors need, but in addition gives an 800 telephone number to call the fund main office for anything one can think of not found in the report. In the Snapshot there is a graph and 4 years of performance data and shows comparisons with the S&P 500 or other indexes and its category data for comparison. It shows asset size. One of the best decision makers is the star rating, whether it is 5 stars down to 1 star or no star for new funds which have not been rated for lack of performance data.

Performance and risk are considered in the star ranking for 3, 5, and 10 years, along with the number of funds in the rating. The standard deviation (risk) is shown along with the mean return. The Snapshot shows fees (load and 12b-1) when appropriate, and the expense ratio. It shows management and tenure of the manager. The style box shows whether the fund is value, blend or growth, and whether the fund is large, mid-cap, small, or any combination of the two groupings.

Morningstar calculates and reports data such a beta, R-Square, and alpha along with turnover and yield. Performance data are given for Year to Date (YTD), 1 month 12 months, annualized 3, 5, and 10 years and since Inception. The asset allocation is shown for each fund. A full report prepared by Morningstar gives close to everything an investor needs.

Question 10: Someone said that a high expense ratio fund would have better management. Explain the issue.

Solution10: Refer to pages 4, 5 and 11. The higher the expense ratio, the lower the return. Any load, 12b-1 fee and operating expense will reduce the return because each is a burden for the return. Anyone with that pitch does not understand what hurts the return...

Question 11: What is a sector fund? Is there any problem with a sector fund?

Solution 11: A sector fund has most if not all of the stocks from a particular sector. The primary problem is diversification. One of the best sectors is "health care". Quite often the sector funds out-perform properly diversified funds, but there is more risk because if something bad happens in the sector, the performance will be hurt more than those well-diversified funds. An example of some of the better performing sector funds are: Vanguard Health Care, T. Rowe Price Health Science, Fidelity Select Medical Equipment and Systems, and Vanguard Energy. With the price of oil at $70 or higher, performance will reflect the higher price. The volatility of the sector will be reflected in the performance of the funds. However the sector goes, so goes the sector funds.

Question 12: In light of this information, what advice do you have for the new faculty member?

Solution 12: In view of the fact that everyone has noticed that the presentation is void of "fixed income" investments of any kind, justification of this absence can be shown using Ibbotson's data that is published in the spring each year. Inflation adjusted Return produces an 86 year "purchasing power" for large cap equities of $244.13 from an investment of $1.00 in early January 1926. (One dollar turned into a purchasing power of $244.13.) The only way this $244.13 can be meaningful is to make the same calculation of $1.00 invested in early January 1926 in Government Bonds which provided an 86 year purchasing power of $9.26. The purchasing power of the Government Bonds is 3.79% of that produced by equities, such as the S&P 500 Index.

Very clearly, my advice is to invest all retirement plan capital in the best equities available. When the investments are mutual funds the choice should be no-load and no 12-1 fee funds to make the best performing portfolio the investor can put together.

BIOGRAPHY

William P. Dukes is The James E. and Elizabeth F. Sowell Professor of Finance. He can be contacted at Finance Department, Rawls College of Business, Texas Tech University, 703 Flint Ave., Lubbock, TX 79409, (806) 834-3419, (806) 742-3197 (FAX), email: william.dukes@ttu.edu

A BAUDRILLARIAN VIEW OF ACCOUNTING GOODWILL

Syaiful Anwar, Universitas Pembangunan Nasional "Veteran" Jawa Timur
Diah Hari Suryaningrum, University of Brawijaya, Indonesia

ABSTRACT

This paper emanates from the understanding of hyperreality – reality, and on the other hand based on the Baudrillarian postmodernist perspective. Thus, we aim to understand hyperreality and reality in accounting from the perspective of Baudrillarian pospodernism. A thesis by Macintosh indicated that today's financial markets operate detached from reality in hyperreality, and there does not exist anything stable to support the financial economy in the "order of simulacrum." Consequently, vital accounting information no longer refers to real references, which mean that we live in a world of free-floating signs. In the simulation era of today's world, accounting, just like all other areas of knowledge, faces a crisis of representation. Goodwill is a hidden value that accounting standards define as the value of future economic benefit (internal goodwill) and the difference between fair value and book value of the firm (business combination). This paper concludes that accounting goodwill represents the order of simulacrum (era of simulacra). These orders of accounting for goodwill are as follows: first, era of proprietary; second, era of political economy; third, era of globalization; and finally, the virtual era. It is also suggested that understanding goodwill is important to determine whether information of goodwill has value relevance for decision-making.

JEL: M41

KEYWORDS: Baudrillarian Postmodernism, Hyperreality, Era of Simulacra, Accounting Goodwill

INTRODUCTION

Accounting can be viewed as a firms' language (Suwardjono, 2010: 28), because accounting has a set of symbols, either words or numbers, which are used to communicate information from the provider of information to the user. Language is an important aspect in communication as language serves as a carrier of messages that contain a specific meaning. Meaning to be conveyed in the language may change over time or may differ depending on the information and the user's ability to read and understand it (Evans, 2010). Evans (2010) observed changes in accounting language using linguistic theory and emphasized his observations on the mechanisms and motivations that led to those changes. His paper concludes that changes in the language of accounting, including the transmission of language and culture, can provide historical information about the transfer of technical development, socio-economic, political or ideological process, power, and jurisdictional terminology. Therefore, the expression in language must be precise so that its meaning can be interpreted as its intended meaning. In order to have value, accounting information has to reflect the reality.

Suwardjono (2010: 29) defines reality as the reality or the physical facts of the company's activities. If reality is defined as a fact or facts, then the company's physical activity is symbolized by the signs of accounting language that should reflect the reality or factual. In this context, accounting will full with the measurement and assessment. Hendriksen and Van Breda (1992: 15) recognized that:

"Accounting number and classifications vary with respect to the degree of interpretation that can be inferred by the reader of accounting reports. For example, the item 'cash' in the statement of financial condition is fairly well understood to mean what accountants intend it to mean. On the other hand, the

classification of 'deferred charges' has no specific interpretation apart from the structural processes that given rise to it."

That is, the numbers and accounting classifications vary greatly depending on the interpretation that can be inferred by the reader of financial statements. For example, "cash" in the statement of financial position (balance sheet) is quite well understood meaning in accordance with the meaning intended by the accountant. Instead, "deferred charges" does not have a specific interpretation to the reader of financial statements. Similarly, does the term "goodwill." Goodwill in the statement of financial position is part of the intangible assets may have a different interpretation to the reader of financial statements.

Goodwill is a concept in accounting (as the result of logical thinking), which seeks to represent part of the company that does not appear in the financial statements and appear only in the event of a merger, both individual and corporate (Zanoni, 2009: 1). In this context, the reality has been reduced to a concept. No longer reflects reality or factual reality, but simply reflects the symbol itself (hyperrelity). If so, does the accounting of goodwill represent a reality or hyperreality? Baudrillard in his attempt to understand the reality and the development of modern society introduced his radical perspective of order of simulacrum as the era of sign. He characterized order of simulacra in four levels: First, the sign reflects the reality that is real and that no sign precedes. Second, the sign to hide or even distort the true nature of reality or that preceded it. Third, there is the absence of a sign to hide the reality. Fourth, the relation between signs and reality are exchanged or reversed, where the existence of sign occurs precedes the existence of reality (Macintosh et al., 2000). The remaining of this essay are developed as follows: the next section is literature review which describes the perspective of Baudrillarian Postmodernism, order of simulacra in financial accounting, and the definition of goodwill. From this point, we make an analysis of accounting goodwill and discuss it in the third section. Finally, the conclusion is set forth in the last section.

LITERATURE REVIEW

In this essay, we examine the accounting goodwill by using the perspective of Baudrillarian postmodernism of order of simulacra. The purpose of this essay is to get an explanation whether the language of accounting, goodwill in particular, able to represent reality and the meaning that was intended by the accountant.

Baudrillarian Perspective (Order of Simulacra)

Macintosh et al. (2000), explains that Baudrillard uses the idea of the simulacrum, implosion, and hyperreality to describe a radical development of post-modern society. A simulacrum is a sign, image, model, pretence, or a shadow that resembles something like the original. Implosion is a condition in which the boundaries between two or more entities, concepts, or the fact has melted, damaged, or destroyed so that such differences are no longer visible. Hyperreality refers to the condition of postmodernity where simulacra (signs, images, or models) are not associated with fact or reality apart from the material object or romantic ideals. In ontology, the postmodern world is currently dominated by linguistic and textual constraints, which is currently more important than the economic reality that shook the era of industrialism.

Baudrillard uses the concept of simulacra, implosion, and hyperreality to describe the development of signs and the reality of relationships in four levels (this does not describe the level of classification which is more important, but rather indicates that one precedes the other). Therefore, Baudrillard reveals the concept as a sign of an era or the order of simulacra. Levels of simulacra of Baudrillard area as follows: First, the sign reflects the reality that is real and that no sign precedes (profound reality). In this era, the sign refers to the appearance of real reality, in which the sign represents an honest and transparent reality. Second, the sign to hide or even distort the true nature of reality or that preceded it. In this era, the sign refers to the appearance of reality is distorted, in the sense of the sign no longer has properties like those of reality. Third, there is the absence of a sign to hide the reality. In this era, the sign, like the magic game, plays the role to create the reality. Lastly, the relation between signs and reality are exchanged or reversed, where the existence of sign occurs precedes the existence of reality. In this era, signs are not related to the reality, or even the reality itself is completely absent or hyperreality (Macintosh et al., 2000).

Order of Simulacra and Financial Accounting

In his article of Hyperreal Finance, McGoun (1997) represents the economic-financial instrument with a game of poker. People play poker by betting tokens (cash or stock), using the token they "play the market." Players can exchange these tokens whenever he pleases, and the players enjoy the thrill of competition and the pride of having his/her token value increased. McGoun describe the level of simulacra associated with the money as follows: The first level describes the general currency symbol (image) of the property. The second stage, which is influenced by Marx Bauldrillard opinion that the "political-economy" is the transmutation of all values (labor, knowledge, social relations, culture, and nature) to the value of economic exchange. The third level, the exchange only reflects the exchange, which is justified by the exchange transactions for consumption. At the fourth level, there is no justification for the transaction. By using Bauldrillard view, the levels one, two and three, excuse or reason for the exchange of money is the "value" of money, but on the fourth level, the reason for the exchange of money is a "sign" of the money itself.

Furthermore McGoun (1997) described that phases or levels can be applied specifically in financial assets, such as stock prices. In the first stage, the stock price accurately represents the intrinsic value of the company. The second stage, the stock price, because of the distortions and market imperfections represent an imperfect indicator of the intrinsic value of the company. The third stage, the stock price is the only value that a company known, and the fourth stage or hyperreal stage, the stock price is only a "sign value" which is completely independent from the value of the company.

Inspired by the writings of McGoun (1997), Macintosh et al. (2000) and Macintosh (2003) analyzed earnings using post-structuralist view. Earnings – which called "net income" by the accountants – is a sign of the sign, and a sign that is no longer represents the intrinsic income, real profit, or real income. The income as reported as an accounting net profit is only a reflection of net income itself (completely detached from reality). Macintosh (2003) used Bauldrillarian view and genealogy sign into four levels (era). The first era referred to as the feudal era; mark this feudal era of accounting in a transparent manner is a reflection of the real object. In this era, in the UK for example, rates and fines actually reflect the real object like a lamb, rice, seeds, and others, which also reflects the social relationship between the employer (lord) with the management / worker (steward). In the partnership of business, profits actually calculated from the results of a project business (venture). In other words, the profit is really divided after a business project ends. So is the capital of passive partner (Commenda), where it describes Commenda (such as members of the church or the nobility) who has participated in a secret partnership for a profit is a sign of exploitation, immorality, and dishonesty.

The second era is the era of falsehood (order of counterfeit). In this era, there was the fall of social hierarchy of feudal era and the birth of democracy. The sign is no longer dominated by hierarchical social levels, rigid, and cannot be bent, but the sign (labor and capital) can circulate freely to all parties. This new class of people (bourgeoisie) demands the freedom of rights, participation in a democracy, and the right to keep their own property. This new society can live like the life style fit for kings, feeding on a set of the best quality of china dishes. These objects represent a sign of "fraud" as false as the owner, who tried to imitate or pretend to be of the nobility (royalty). This era is the emerging signs of accounting "profits (earnings)," - which represent as the emergence of business (venture) with a permanent capital investment based on business ownership (in India in the mid 1660's). There was also an idea of the continuity of business (going concern), so the company must continue to calculate its earnings on a periodic basis. Accounting earnings represent reality that originally divided at the end of a business, but now imitated in profits as if the business is no longer exist. A sign of accounting "profit" merely reflects the "obligatory of sign" which is still associated with "real income," income is only a reality of existence as being real. (Macintosh et al., 2000; Macintosh, 2003).

The third era is the era of production. With the advent of the era of production in the 18th century, accounting earnings mark a radical change. In this era, which by Bauldrillard referred to as "industry of simulacra," an era in which the production technology capable of producing artificial goods; the object is no longer a reflection, counterfeiting, or analogies of the original stuff, but just a clone of a production. Therefore, the sign is the object and the object is a sign. Social levels also experience changes characterized by the production rules, rights, and laws. Signs of accounting earnings also changed with the development corporation and the shareholder's absence. Capital has the same meaning as aggregation or collection of assets and liabilities in the company. Profit is no longer the result of a business owner, but is the result of the capital. Emerging what is known as entity that replaces the partnership or proprietary (Macintosh et al., 2000; Macintosh, 2003).

The fourth era is the era of simulation. Realism nonmaterial signs that go beyond material economics of commodity production, consumption, and exchange mark this era. Bauldrillard suggested a new era: "... the organization of society According to simulations, codes, and replaced production models as the organizing principles of society." A new era that is also known as hyperreality, where there are indications that the signs are no longer directly refer as a referent, or that the sign is no longer a forgery of a specific reference, or a sign does not absorb or dominate object, but purely a sign reflecting the sign itself (pure simulacra). Another term used is homo semioticus replace homo economicus. In this era, a sign of accounting "earnings" gave rise to the concept of "earnings management" refers to the smoothing of income (income smoothing) or for a certain academia as the manipulation of earnings and forecast analysis (Macintosh et al., 2000; Macintosh, 2003).

Macintosh (2003) concluded that many accounting symbol that does not have a clear reference to the object or real events, so that the accounting does not fully perform its functions according to the logic of representation, accountability, or the presentation of economic information in a transparent manner. Not much different from Macintosh conclusion, Riduwan et al. (2009), in a study of critical-postmodernist Derridean, implies that: first, the presentation of income statement should disclose earnings information in accordance with the pragmatic interpretation of the frame. Second, reporting income information not only to favor idealism, given the end users are those who profit information in pragmatic habitus. Third, idealism should limit the application of accounting principles in the transaction and the accrual of real events, or reduce its application in the event that there is only limited to the idea or concept.

Defining Goodwill

Some philosophers thought that definition or conception of conduct could be considered as acts that tend to confine (to hegemony) a person's thinking. As expressed by Antonio Gramsci (1891-1937), hegemony is a form of oppression against the way of thinking (especially thinking of oppression by the capitalist). Gramsci suggested the need for liberation from the hegemony (Santoso et al., 2007: 71-911). However, in this essay we still make the definition or conception, with the aim not to create hegemony but rather to limit the scope of writing. Definition is the part that cannot be separated from the concepts of accounting, as required in the definition of the concept formation. Definition and concept is not different, because they provide an explanation (description) to represent something that cannot be observed directly, with the aim that "something" that makes the human mind. Therefore, to understand the same thoughts about the goodwill, it would require the definition of goodwill.

Hendriksen and Van Breda (1992: 637) stated that if a name can be assigned to intangible assets, indicating that these assets are assets that can be identified. Intangible assets such as goodwill cannot be identified. Intangible assets, although it has no substance, just like other assets, must meet the criteria for recognition of an asset; which are must be measurable and must be relevant and reliable. Should goodwill be recognized? Given that, goodwill is an example of intangible assets having a high uncertainty. It was described that goodwill may be recognized at a given time by comparing the market value of companies with net assets of the carrying amount, and if the market value is higher than its carrying value, goodwill is part of the company's assets. From this viewpoint, it is difficult to associate with the cost of goodwill or business income, so there is no point to capitalize goodwill or treated as a reduction of revenue at the time of goodwill occurs (APB 17).

Scott (2009: 231) defines goodwill as the present value of abnormal earnings in the future in relation to intangible assets. Goodwill relationship with abnormal earnings based on the economic realities of corporate value, so the value of goodwill is equivalent to the capitalization of abnormal earnings stream expected to firm. The equation is stated as:

$$G = [\frac{I-(ke\ x\ B)}{ke}]$$

where

G = goodwill
I= perpetual expected earning flow
Ke= cost of equity
B: equity book value; dan I – (ke x B): *abnormal earning* (Zanoni, 2009: 2).

That is, a company will have goodwill if the intangible assets generate abnormal profits. Based on this definition, then the goodwill is an intangible asset arising from the internal assessment. Example of measurement of goodwill is:

The Company has a net asset value of $240,000 and annual net income of $60,000, and return on investment of 25%. If the normal market return is 10%, earnings $60.000 states that the total assets worth $600,000. The Excess return of 15% above normal returns from goodwill or any intangible assets will amount to $ 360,000. If the intangible assets identified worth of $240,000 then the goodwill will be $ 120,000 (Beams et al., 2009).

APB 16 recommends that when a business combination is considered as a purchase, the acquired assets should be recorded at fair value or the fair value of the consideration that is made in exchange. This view is consistent with the historical cost concept, which states that assets should be recorded at the time of passage if given consideration cannot be measured clearly. APB 17 also states that, if the cost of an acquired company is less than the market value / assessed value of the identifiable assets minus liabilities, the difference shall be allocated to reduce the value of non-current assets (Belkaoui, 2000). Goodwill can be recognized at any time by comparing the market value of a company with a value of net assets. Equities increased in value by recognizing goodwill. But goodwill is a benefit that cannot be specifically identified, so there is a lack of logical reasoning to associate those costs with any specific income in future periods. Treatment of assets that cannot be identified is still unclear, assets that cannot be identified do not have a semantic interpretation, and therefore not relevant so that should not be recognized as intangible assets.

Therefore, it can be concluded that goodwill is part of intangible assets as a corporate asset valuation accounts that cannot be identified. Goodwill can occur in two ways, namely the assessment of internal valuation or arise from the merger process. Goodwill arising from the internal assessment is measured by assuming that the goodwill is the discounted present value of future earnings in excess of what is expected as a normal return (abnormal return), while the goodwill of a business combination are measured by comparing the fair value and carrying value of the company's net assets.

ORDER OF SIMULACRA OF ACCOUNTING GOODWILL

In line with the thinking of McGoun (1997), Macintosh et al. (2000), and Macintosh (2003), we try to analyze the accounting of goodwill by using the perspective of postmodernism Bauldrillarian. We propose the order of simulacra of goodwill as follows:

Era of Proprietary

The first era is the era of proprietary, in which a sign, symbol, or image reflects the owner's property. Proprietorship term originally appeared in the attempt to put on an exposition of the logic of double-entry (double-entry bookkeeping). In accounting, the equation is: $\sum A - \sum L = P$, where the proprietor (owner) is the center of interest. Assumed assets and liabilities owned by the proprietor is the proprietor liability, so the net value of the proprietorship is a business proprietor (Hendriksen and Van Breda, 1992: 770). When a business starts, the company's value equals the value of the initial investment of the owner. With the passage of the business, this value will change to the initial value plus the accumulated investment earnings and will be reduced by the net loss or withdrawal by the owner. This becomes the concept of wealth. Thus, in this era, theory of proprietary is a logical partnership framework under the law and most appropriate be applied to a single union (single proprietorship).

In this era, business is still a venture where business is limited to one ship route trip. In my opinion, goodwill has not yet emerged, because the owners are only concerned for his own fortune. In addition, the form of business combination is still not widely known. Even if there is no assessment or company business combination, goodwill is more suitable recognized as a reduction of income or as expenses that will form the property owner (Hendriksen and Van Breda, 1992: 637). The reason given by Hendriksen and Van Breda is to recognize and assess the fair value of goodwill by comparing the company with net assets of the carrying amount is difficult. How we determine that the value of the company represents the fair value of real world if the company does not actually being liquidated? As expressed by Macintosh (2003), in this era, business is still dominated by individual businesses, so individual company sets the value. Takeover of an individual business by another will depend on its owner, as the owner determines how wealth he has.

Era of Production (Political-Economy)

The second era is the era of political economy, where there are various interests that tried to be served by the reporting of goodwill accounting. McGoun (1997) revealed that in the era of "political-economy" there was a transmutation of all values (labor, knowledge, social relations, culture, and nature) to the value of economic exchange. In an era of booming capitalism, there were many efforts in the development area, including efforts to replace individual owners (proprietary) to the mass production. Which in turn makes the difference of interest among the stakeholders of the company became increasingly sharp. Various theories of accounting that is based on economic theory emerged in this era to explain accounting practices. These theories include dynamic capabilities theory, enterprise management theory (enterprise equilibrium theory), which became the basis of valuation of internal goodwill. The theory of capital, in which the economic shift from an agricultural economy to trade, and eventually became the industry economy, making the capital as a factor of production, which eventually resulted in a shift towards intangible dimension, social, and dynamic. Zanoni (2009: xii) provide examples such as theories of human capital theory, social capital, and intellectual capital, which seeks to explain that the value company may be caused by the human resource excellence, social, and intellectual property.

These theories cannot be separated from the emergence of a Political Economy of Accounting (PEA) paradigm. PEA asserts that accounting (practice and research) should be analyzed through three approaches, namely the normative, descriptive, and critical (Cooper and Sherer, 1984). Normative approach emphasizes the normative elements and an assessment of the social. That is, accounting is identified and evaluated with variety of paradigms. The political and social values influence the choices of accounting. Descriptive approach emphasizes that accounting is a practical thing. It is influenced by the behavior of individuals and classes that exist within or outside the organization. As to better understand, the accounting practices need to be a descriptive approach. Critical approach emphasizes critical awareness to develop and evaluate alternative paradigms and methods that combine a variety of accounting interests.

Although there has been a shift in accounting, accounting goodwill still insists on the principle of historical value. Example of Accounting Goodwill - Historical Cost Accounting is as follows:

"P companies pay for Rp87.000.000, - to acquire the S company's voting stock outstanding at the date of January 1, 2011 when the company's shareholders' equity consists of share capital of Rp60.000.000, - and retained earnings amounting to 30,000,000, - Calculation of goodwill company is recognized for Rp15.000.000, - {Rp87.000.000 - (Rp90.000.000 x 80%)." (Beams et al., 2009)

Goodwill calculation shows that the company's P (parent) recognizes the S company's net worth only 80% of the value of its subsidiaries.

Based on historical accounting concepts, we argue that in this era, goodwill valuation approach is done by the Income Statement approach. Measurement and valuation of goodwill is mainly aimed to make the allocation of the historical value of the company, either by technique of amortization of assets or by technique of impairment of goodwill. As revealed by Riduwan et al. (2009) that earnings do not represent reality. A sign of accounting "profit" merely reflects the "obligatory of sign" which is still associated with "real income," income is only a reality of existence (being real). Therefore, the sign of goodwill is also just a reality of existence or being real.

Era of Globalization

The third era is the era of globalization, where accounting attempted to be globally standardized with the implementation of International Financial Reporting Standards (IFRS). Here are the reasons why Indonesia adopts IFRS as stated by the Chairman of the National Board of IAI (Indonesian Accounting Institute), Ahmadi Hadibroto:

IFRS is a strategic step toward uniformity of "language" in the accounting and financial reporting as the main agenda of the global accounting profession. The creation of global harmonization of accounting standards is also one of the objectives and commitments of the G-20 in enhancing the cooperation of the world economy. Global standards enable the comparability and exchange of information. IFRS convergence may enhance the information of the financial statements of companies in Indonesia. Adoption of international standards is also very important in order to stabilize the economy. The benefits of IFRS convergence program is expected to reduce investment barriers, improve corporate transparency, reducing costs associated with the preparation of financial statements, and reduce the cost of capital. The goal of financial statements prepared by the IFRSs will only require a bit of reconciliation to produce financial statements.

The interesting part about the statement is the uniformity of language, economic stability, and benefits of IFRS adoption. From here, it seems that adoption of IFRS did not see the factual reality of the situation and conditions in Indonesia, but rather look at globalization simulacra (is it possible that many countries with its cultural, community, social interaction, legal, and others be made uniform?) Research of implementation of IFRS in Indonesia (Chariri and Hendro, 2010; Wahyuni and Lay, 2010; Boediono, 2008) provide evidence that IFRS is suitable in Indonesia. Unfortunately, there is no research about whether harmonization or adoption of IFRS is in accordance with local cultural and spiritual values in Indonesia. There is also no reasearh evidence that could prove that Indonesia is necessary to adopt IFRS (the reality of Indonesia).

The main principle of the background for IFRS is a principle of comparability and uniformity with emphasis on the approach to fair value (fair value accounting). Todd Johnson, a FASB staff expressed (2005, as quoted by Ball, 2005):

"The Board has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors and creditors than historical cost information. Such measures better reflect the present financial state of reporting entities and better facilitate assessing their past performance and future prospects. In that regard, the Board does not accept the view that reliability should outweigh relevance for financial statement measures."

Accounting for goodwill is mainly set in conjunction with the acquisition of companies or businesses combination (IFRS 3 and IAS 36):

All business combinations are accounted for by applying the purchase method, requiring that one entity is identified as acquirer (IFRS3.17). The difference between the cost of the business combination and the fair value of the assets and liabilities acquired represents goodwill (IFRS 3.51). Goodwill is not subject to amortisation, but is assessed for impairment at least annually (IFRS3.54 and IAS36.10). Impairment is charged to the income statement (IAS36.60).

Examples of goodwill according to IFRS accounting (fair value accounting):

P companies pay for Rp87.000.000, - to acquire the company's voting stock outstanding at the date of January 1, 2011 when the company's shareholders' equity consists of share capital of Rp60.000.000, - and retained earnings amounting to 30,000,000, - Calculation of goodwill company is recognized for Rp18.750.000, - {(Rp87.000.000/80%) - Rp90.000.000). (Beams et al., 2009)

Goodwill calculation shows that the company's P (parent) recognizes the company's net worth (the subsidiary) at 100% of the value of its subsidiaries. With this calculation, the value of goodwill will be larger than the measurement of goodwill in the previous era (Rp15.000.000). This makes the company's assets to be larger and the potential impairment of goodwill will significantly would reduce corporate profits.

At this time, the entity theory is emphasized in the new corporate entity, although in reality (legally) the new entity does not exist. Based on the new entity theory and principles of relevance, we argue that accounting goodwill in this era of emphasis on the balance sheet approach, in which the accountant seeks to provide information about the company's assets at balance sheet date (not the historical value of the property companies). It appears that in this era, the object (goodwill) is no longer a reflection, counterfeiting, or analogies of the original item, but only an imitation of a mass production (global).

Era of Virtuality

Lastly, the fourth era is the virtual era, where the boundaries of the world and social communities have disappeared altogether. Forms of companies in the future no longer looks real (mortal and brick) but rather in virtual form (form of company in cyberspace). Information and communication technology revolution has eliminated national borders, time and space to interact and communicate with each other to form a global community. Technological development has also brought a lot of change, especially in transaction activity. Flow of goods and services not only through the customs area from one country to another, but also through electronic transfer (virtual). Consumers can purchase goods easily through the internet, and in a short time to hand the goods. Trading in the virtual world known as e-commerce has the potential to be one of the largest wheel drive economic development in the future.

In addition, the traffic cash payments as an instrument to assess the transaction will also undergo radical change. Money no longer seem real (paper form), but transformed into another form of the electronic money (e-money). E-money can be formed as card-based product and software based product (Suryaningrum and Hastuti, 2010). E-money in the form of card-based products is often referred to as electronic purses, which are principally intended for direct payment (face to face). While software based product is often, called digital cash, in principle, is an application (software) is installed into a Personal Computer (PC) that runs with the standard operating system that was developed to conduct transactions via a computer network (internet). Mechanical technique that is used to manipulate the data of "value of money" is balance-based techniques. The concept is to apply the principles used in bookkeeping process in which each transaction shall be treated as the debit or credit which would then affect the outstanding (balance) contained in the e-money.

In this era, simulation occurs, there are indications that the signs are no longer directly refer to a reference (referent), or that the sign is no longer a forgery of a specific reference, or sign does not absorb or dominate an object, but purely a sign reflecting the sign itself (pure simulacra). The Company is no longer a referent of the company, and money is no longer the referent of money. As a result, the value of goodwill as a form of company will be very difficult to be measured and assessed considering the company itself exists only in cyberspace (virtual). Thus, the important question remains: is it still necessary to have the accounting goodwill in the future?

CONCLUSION

The objective of this essay is to understand whether the term goodwill have a meaning that represent the reality of accounting transaction and reporting. On the study of accounting goodwill, I use the perspective Baudrillarian order of simulacra, and concluded that accounting goodwill were divided in four era: 1) the era of ownership (proprietorship), 2) the era of production (political economy), 3) the era of globalization, and 4) the virtual era. In the earlier era, the accounting of goodwill still represent a reality of accounting transaction, but along with the development of social, business, technology in accounting transactions, this concept of goodwill has been changed. Goodwill seems to represent the hyperreality of accounting transaction.

Review of goodwill accounting in this essay is limited to literature study and our own interpretation, so it needs further study with a variety of paradigms such as Interpretive, critical, or postmodernists. Qualitative research is appropriate to be used, since it digs deeper into the meaning of goodwill by the parties related to the company (stakeholders), not only investors, shareholders, auditors, and governments, but also the management accountant, accountants' educators, or other parties. Besides that, it seems necessary to answer the question "is information of goodwill still useful for decision maker?"

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BIOGRAFY

Syaiful Anwar is a lecturer and researcher at Universitas Pembangunan Nasional "Veteran" Jawa Timur – Indonesia, in accounting program of the Economic Faculty. His research interest includes accounting theory, financial accounting, and information system. He is a member of Indonesian Economist Association (ISEI) and Economist and Faculty Forum (FORDES). Email address: saifulupn@yahoo.com.

Diah Hari Suryaningrum is a doctoral student of accounting program at University of Brawijaya, Malang – Indonesia. Her research interest includes information system, ethics, accounting education and accounting behavior. She is a lecturer and researcher at Universitas Pembangunan Nasional "Veteran" Jawa Timur – Indonesia in accounting program of the Economic Faculty. She is a member of Indonesian Economist Association (ISEI), Economist and Faculty Forum (FORDES), and staff member Institute of Indonesian Accountants (IAI) East Java, Research and Development Unit for 2008-2012 periods. Email address: diahningrum_upnjatim@hotmail.com.

FACTORS THAT IMPEDE VIABLE BOND MARKET DEVELOPMENT IN ONE HYPERINFLATIONARY ECONOMY

Dennis Sibanda, Vaal University of Technology
Job Dubihlela, Vaal University of Technology

ABSTRACT

This study offers an assessment of the viability of the fixed income securities market for one hyper-inflationary economy since 1997 when its financial market took a volatile shape. The financial sector (banks) continues to grapple in trying to address inflationary pressures, while long term lending for capital development (bond market) including the secondary market is struggling to "take off the ground". The combined effects of short-term interest rate volatility, political instability and hyperinflation in the Zimbabwean economy led to great uncertainty in its securities market and consequently, to unstable bond market. Data were collected through secondary sources and additionally, surveys were carried out; shows that inflation is the main factor contributing to the uncontrollable volatility of short term interest rates. The subsequent effect of inflationary pressures increased uncertainty in pricing of long term securities such as bonds. Empirical findings, expert advice, facts and opinions were used, with recommendations on what needs to be done to salvage the securities market in Zimbabwe, and to create a viable and stable fixed income market (imperative for capital investment and infrastructure development).

JEL: E6

KEYWORDS: Rules versus Discretion, Stabilization, Treasury, Bond market, Hyper-inflation, Financial Markets, Market volatility, Interest rates, Zimbabwe

INTRODUCTION

The relationship between financial market development and economic growth has received considerable attention over the years. Increased availability of financial instruments reduces transaction and information costs and promotes growth in the economy by helping economic agents hedge, trade, and pool risks in attracting investments (Wachtel, 2001). Developing a viable bond market provides stable and predictable sources of funding for borrowers and reliable sources of income for investors (Aggrawal, Inclan & Leal, 1999). Participants are able to pursue investment activities with known costs of funds and returns (Hirotaka, 1997). Infrastructural development projects with marginal economic returns sensitive to the cost of funds can proceed on the basis of more certain funding costs (Arnold & Vrugt, 2006) obtained through access to the bond markets while providing investors with predictable cash flows (Bukley, 1998; German, 1977; Cagan, 1956). The vast majority of literature on finance and growth has largely ignored the bond markets despite their role as an essential source of external finance (Boyd, Levine & Smith, 2001). Financial markets and banks may provide complementary growth-enhancing financial services to the economy (Fink, Haiss & Hristoforova, 2003).

This study offers an assessment of the impact of money market rate volatility on the viability of the Zimbabwean fixed income security market (Brennan & Schwartz, 1979). The combined effects of political instability and hyperinflation in Zimbabwe have led to great uncertainty in the securities market and consequently, to unstable bond market (Bekaert & Harvey, 1997). The money market, which is an indicator of the short term interest rates (Bernanke, Gertler & Gilchrist, 1996), has been characterized by major fluctuations hitting all time high rate of 850% per annum in March 2006. More recently (Feb 2009, the rates have been depressed to as low as 0 to 100 % for investment periods ranging from 7 days to 365 days). Such interest rate fluctuations create significant uncertainty in the pricing of interest-bearing instruments (Beckers, Grinold & Khan, 1994). The intensity of these fluctuations, make it necessary to look at their effect on the bond market development in Zimbabwe.

This paper is organized as follows; next is a brief review of related literature, followed by some contemporary issues on Zimbabwe, which forms the basis for identification in this study. The empirical analysis together with the discussion of the results is provided in section three, followed by the concluding comments and implications for future research.

LITERATURE REVIEW

Price stability is a crucial prerequisite for developing viable longer term fixed interest financial markets (Bernanke et al, 1999; Bernanke et al, 1996, Dalla & Khatkhate, 1996; Fischer, 1975). For example, the continued high inflation impedes development of the market for fixed rate governments bonds (Burger & Warnock, 2006; Blake, 1991). Two cases in point can be sighted; (1) In Jamaica, a continued high inflation impeded the development of the market for fixed rate governments bonds (Arnold & Vrugt, 2006), (2) A report by the Regional Economic Monitoring Unit for the Asian Development Bank (2002) stated that a robust domestic bond market was unlikely to evolve in a volatile macroeconomic environment characterized by volatile inflation and interest rates, confirming the findings of Culberison (1957) and Arnold and Vrugt (2006).

The bond market fails to take off largely as a result of the unstable interest rate regime (Daher El Samir, 1997). Existing research (Cecchetti, Genberg, Lipsky & Wadhwani, 2000; Bernanke & Gertler, 1999; Fischer, 1975; Dieffenbach, 1975; Bierwag & Grove, 1967; Duesenberry, 1958) enlist about four key prerequisites for a successful bond market; the macroeconomic stability, fiscal discipline, improved legal, accounting and regulatory systems for the financial sector, and a sound tax system. Investors are unwilling to stretch their investments to more than a year because of the uncertainty in the macro-economic investment climate (Dornbush; 1996; Long, 1974; Hakansson, 1970). The money market takes a volatile shape as most of the money market participants (Banks) have the products tailor-made to address inflationary pressures while the long term lending for capital development (Bond market) including the secondary market is struggling to "take off the ground". According to Yam (1999), the existence of an efficient bond market lies in the hive of the primary bond market and the liquidity of the secondary bond market. In other words, the bond market ensures an adequate supply of new capital in the primary bond market. In support of this assertion, Mohanty (2001) cites the lack of liquidity as the major obstacle to the development of a viable bond market.

A banking sector that is free from political interference and operating on economic principles (Levine, 1997) can be an important ingredient to the development of a viable bond market. Burger and Warnock (2004) posit that countries with strong banking institutions have broader local currency bond markets. Efficient bond markets require an environment where there is a healthy interplay between demand and supply elements which facilitate the price discovery process and results in adequate market depth and liquidity (Briers, 1999). Ngiam Kee Jin (2002) identifies the 'original sin' problem as real. It states that 'any country hoping to build a viable bond market must understand the conditions' that lead to a successful economy. A country with sovereign risk, high inflation and an unstable currency will find it difficult to develop its domestic bond market. Such an economy is said to have the 'original sin' problem. Sovereign risk arises when repayments from domestic borrowers can easily be interrupted because of interference from the national government. According to Eichengreen and Hausmann (1999), 'original sin' is the inability of developing economies to borrow from international financiers using local currencies. Investors become nervous about investing in domestic currency denominated assets; and hence perpetual depletion of Foreign Direct Investments.

In his earlier study, Dothan (1978) argues that a banking sector that is free from political interference and operating on market principles can be an important ingredient to the development of a viable bond market. His assertions were supported by Arnold and Vrugt (2006). Burger and Warnock (2004) also agreed with these arguments and contended that countries with strong banking institutions have broader local currency bond markets. Efficient bond markets require an environment where there is a healthy interplay between demand and supply elements (De Leeuw, 1965; Feller, 1951) which facilitates the price discovery. Researchers provide that the major barriers to the development of bond markets include: non-uniform issuing practices, antiquated trading infrastructure, non-existent benchmark yield curves, lack of credible domestic rating agencies, unfavorable regulatory and tax treatment, and a shortage of both supply and demand for bonds (Briers *et al,* 1999).

Description of the Zimbabwean Economy

Once the breadbasket of Southern Africa, Zimbabwe is now a fragile nation with a population of 12.5 million in 2010, and a gross national income per capita estimated in the same year to be less than US$160, compared to sub-Saharan Africa average of US$1,428 (Bekaert & Harvey, 1997), making it one of the poorest countries in the world. During the last decade (years 2000 to 2010), Zimbabwe's economic activity fell drastically (Reserve Bank of Zimbabwe, 2008). Real gross domestic product (GDP) growth recorded a cumulative contraction of about 48%, representing upward of 5% annual decline (Central Statistics Office, 2010). The decline cut across all key sectors, despite Zimbabwe's rich resource endowment (Reserve Bank of Zimbabwe, 2010). Agricultural value-addition contracted by 86% during the period 2002-2008 (Biti, 2009). A viable bond market is an alternative that deserves a priority in the financial sector development agenda (Arnold & Vrugt, 2006; Bernanke & Gertler, 1999; Blake, 1991; Beja, 1979). The country has been increasingly isolated from the international community and the financial sector continues to diminish greatly (Central Statistics Office, 2010). The Zimbabwean government relies heavily on debt financing contradicts fiscal prudence (Turner, 2003).

Fiscal prudence states that high government deficits and huge debts destroy credibility (Cecchetti, Genberg, Lipsky & Wadhwani, 2000; Dornbusch, 1996). In Zimbabwe, new debt is issued to acquire the necessary funds to pay off old debt falling due. According to an African Markets Research Article (August 2006), the half-year government revenue amounted to $76 Billion whilst the expenditure amounted to $90.8 Billion leaving a half year budget deficit of $17.8 Billion, financed through 91 day treasury bills. Over 96.5% of government debt was in fact in the form of 91 day treasury bills. The government alone became the largest borrower for 2007, thus crowded out other essential borrowers for productive sector (Reserve Bank of Zimbabwe, 2007).

The Central Bank routinely printed money to fund the budget deficit, causing the official annual inflation rate to rise at astronomical rates. The past ten years has seen inflation spiraling sharply from an annual rate of 20% in 1997, to 133% in 2004, 585% in 2005, over 1000% in 2006, through a peak of 5594% in 2007 to a staggering 231000% in 2008 (Reserve Bank of Zimbabwe, 2010). Meanwhile, the official exchange rate fell from approximately 1 (revalued) Zimbabwean dollar per US dollar in 2003 to more than 17,500 per US dollar in 2007 and in 2008 it got into billions.

Total government debt stood at $175.66 billion in 2008. Out of this total debt, outstanding government stock was $1.63 billion (representing only 1%), Treasury Bills at cost constituted $59.13 billion (34%) while the Treasury bill interest component was $114.90 billion (over 65%). This clearly shows that the role of the Treasury bond financing has consistently been reduced as a percentage of the total debt of the government. Government debt service can consume a significant part of government revenues, especially given that the interest cost of borrowing rises quickly along with increases in the outstanding stock of debt, especially in inflationary financial markets (Aggrarwal, Inclan & Leal, 1999). In Zimbabwe, given that financial resources are limited, expansions in government debt will more easily lead to higher debt costs. Even after the fall of the decade in 2010, the government continues to struggle to clear government debt by borrowing to repay previously existing debt. The government domestic debt continues increasing rapidly against the background of increased expenditure demands by the government. This is mainly because of the need to finance the government budget deficit (Brennan & Schwartz, 1979), accumulate foreign and domestic assets, as well as repay other previously incurred debts (Biti, 2009).

The financial sector stopped function intensively in 2007. In 2008 the Central Bank stopped printing local currency as it became worthless (Africa Research Bulletin, 2010). The whole economy then relied on individuals employed in foreign countries) sending money home to support their relatives. These are popularly known as the 'Diaspora' inflows. At the beginning of 2009, the economy abandoned the local currency and adopted both the US dollar and the South African rand as the official currencies. This has apparently not added value to the currency flow in the economy. Although inflation stabilized between 3% and 10% in 2009, it has not ignited meaningful economic development.

The use of the US dollar and the SA rand as official currencies also called the 'dollarization' has militated against the economy. Salaries are at their lowest levels and this has not encouraged savings and investments (Raftopoulos, 2005). The coalition government that took over the reins of power in 2009 promulgated a more stable and liberalized economic environment. In response to this positive development, real GDP was estimated to have grown by 4.7% in 2009 (higher than earlier IMF projection of -2.8%), compared with a decline of about 14% in 2008 (Biti, 2009). This was underpinned by the restoration of business confidence as reflected by the gradual improvement of capacity utilization and anticipated recovery in agriculture and manufacturing (Central Statistics Office, 2009). The capacity utilization in manufacturing rose from less than 10% in 2008 to nearly 30% in 2010. Some mines have reopened, taking advantage of the removal of forced foreign exchange surrender requirements and full retention of market proceeds. The hyperinflation of the decade has been brought to a partial halt, reflecting the dollarization of the economy and the end of monetary injections. From January to October 2009, month-on-month inflation remained low and stable, fluctuating between 3% and 7%. Inflation is expected to remain stable in the short run, reflecting a continuation of these favorable developments.

Notwithstanding these economic turn-around efforts by the coalition government, the country continues to face major challenges. Arrears of some US$3.2 billion on external public debt impose significant limits on the amount of support available from development partners. Moreover, the public debt overhang of about US$6 billion (about 170% of GDP) constrains access to international capital markets and discourages private investment (Mahony, 2001; Cagan, 1956).Deterioration in the basic infrastructure is a key impediment to economic recovery in both the short- and medium-term (Valle, 2006; Daher El Samir, 1997). Concerns about the security and the rule of law coupled with concerns about inadequate protection of property rights have led to sagging private sector confidence (Arnold & Vrugt, 2006).Food insecurity, the rising incidence of malnutrition, deterioration and poor access to clean water, medicines and other health services have eroded the quality of life for a majority of the population. There is a severe shortage of official and private external financing, there are very little foreign direct investment funds flowing in (RBZ, 2006).Erosion of human and institutional capacities (Malkiel, 1966) in the public and private sectors continues to impede the capacity for economic reform and delivery of basic services (Central Statistics Office, 2009).

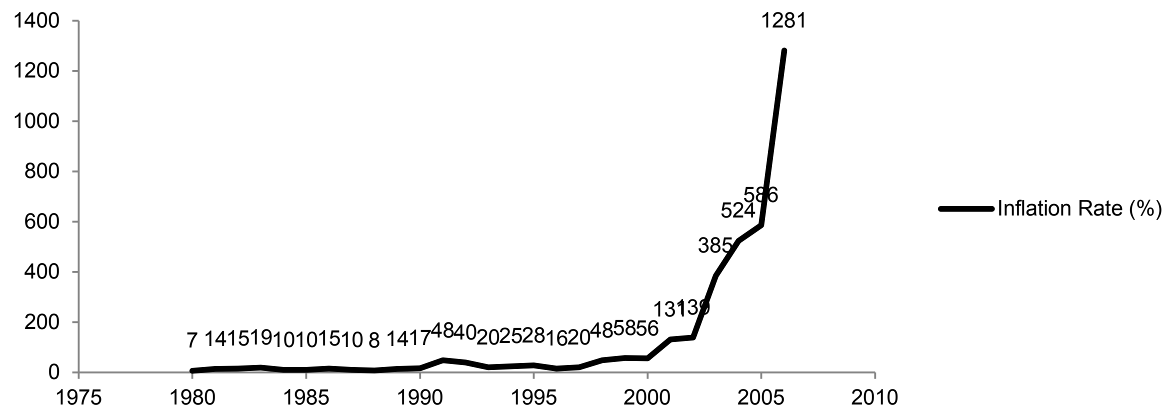
METHODOLOGY

The study employs annualized data for Zimbabwe. The principal source for the data on interest rates, inflation rates and government debt is the Central Statistics Office (CSO) and the Reserve Bank of Zimbabwe (RBZ) websites. The study identifies factors that impede the development of a bond market in Zimbabwe. Although the interest rates were obtained as monthly data, they were annualized. Additionally surveys were carried out to establish the activities and opinions of key players in the financial services market of the economic.

RESULTS

The money market, which is an indicator of the short term interest rates (Dalla & Khatkhate, 1996; Cox, Ingersoll & Ross, 1985 & 1981; Beja, 1979; Hicks, 1946) have been characterised by major fluctuations hitting the all times high rate of 850 % in 2006. The subsequent two years (2008) saw the interest rates depressed to as low as 200% for investment periods ranging from 7 days to 365 days against inflation of 231000%.

Figure 1: Inflation Rates (1980-2008)



Source: Reserve Bank of Zimbabwe (2009)-shows the inflation rates from 1980 to 2008. The trend indicates a phenomenal spiralling behaviour over the last decade starting in year 2000.

In 1980, when the country got its independence, the inflation rate was 7%, it slightly rose over a 10-year period to 17%. By the year 2000 the inflation had gone up 8 times over to 56% and by the year 2007 it had reached phenomenal 5-digit levels above 2400%. In October of 2008, the inflation was going up every day, reaching highs of 231051%. This had an adverse impact on the economy. Repeated attempts to support the currency by raising interest rates harms the financial position of firms as a result of the rise in the short term interest rate, given the absence of long term, fixed rate debt (Bordo, Meissner & Redish, 2003). Deep and liquid bond markets offer a way to cushion the impact of banking crises when they arise (Mohanty, 2001; Valle, 2000). In other words, bond markets play a pivotal role in the development of stable and efficient financial markets (Cecchetti et al, 2000; Bernanke et al, 1996).

The usefulness of domestic debt markets can also be seen in the context of countries that are dependent on aid flows (Copeland & Weston, 2001; Aggrawal et al 1999), like Zimbabwe in this case. International aid is often linked to project financing and can therefore not finance capital projects not supported by the donors. Furthermore, the supply of foreign financing is uncertain, and dependent on the aid agencies' budgets and assessment of economic performance in the recipient country. What the economy needs is capital injection through foreign direct investments and a viable capital market. The debt market in Zimbabwe is largely a captive market (German, 1977); a high proportion of the government securities are held by commercial banks and finance companies. These organizations hold stock mainly to fulfill the minimum liquid asset requirement. The subsequent table (Table 1) provides an iteration of the investor base over a 13year period to 2005.

While commercial banks enjoy a relatively high income from government debt, their large holdings of government stocks (Table 1 above) reflect some fundamental shortcomings in the commercial banking operations. These shortcomings include institutional weaknesses that undermine lending to the private sector, given ineffective screening and monitoring capabilities of loans, little reliable information on creditworthy borrowers, and weak legal systems (World Bank: IMF, 2001). The remainder of the government securities are also held (usually to maturity) by insurance companies as prescribed asset requirements, therefore there is little trading of these securities in the secondary market.

Table 1: Investor Base at a Glance

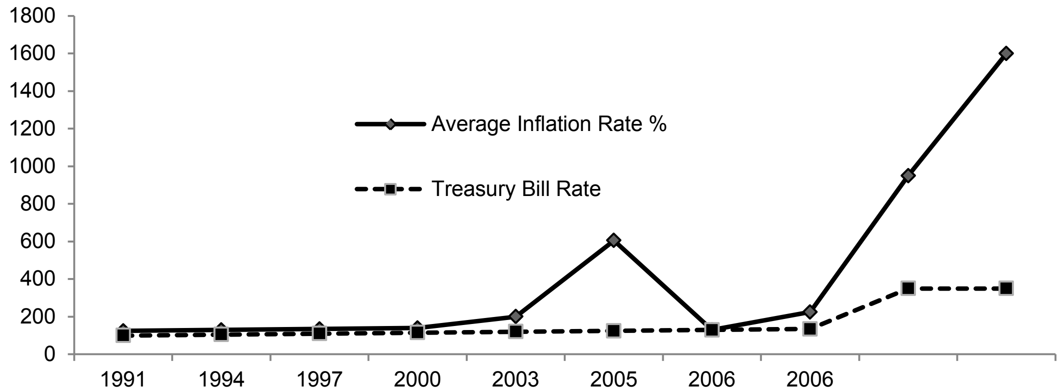
Investor Base of Government Securities (US$million)							
Years	Commercial Banks			% held by Commercial Banks	Others*		Total Government Securities
	Investment in T-bills	*Investment in T-bonds*	*Total Investment*		*Others**	*% held by Others*	
1993	2161	3251	5412	87.72%	757	12.28%	6170
1994	1773	5053	6826	90.66%	703	9.34%	7530
1995	1998	5934	7932	91.39%	747	8.61%	8680
1996	3362	6403	9765	87.34%	1414	12.66%	11180
1997	4660	6945	11605	84.71%	2094	15.29%	13700
1998	4798	7975	12773	82.68%	2676	17.32%	15450
1999	4888	8681	13569	84.23%	2540	15.77%	16110
2000	3661	10092	15753	84.88%	2806	15.12%	18560
2001	5939	11599	17538	85.55%	2962	14.45%	20500
2002	6738	12145	18883	86.26%	3006	13.74%	21890
2003	8103	18398	26502	92.57%	2128	7.43%	28630
2004	11264	19684	30948	87.67%	4351	12.33%	35300
2005	11023	22694	33718	77.98%	9521	22.02%	43240

Source: Central Statistics Office (2006) - shows that the majority of government securities are held by commercial banks;. There is a sizeable increase in the total government securities over the indicated period in the table. Others include corporations, insurance companies, asset managers, discount houses, merchant banks and other investors*

Inflationary pressures prevailing in the economy have eroded the purchasing power of the nominal returns earned (Arnold & Vrugt, 2006). The bond market is slowly dying a natural death as few and few bonds are issued due to the hyperinflationary environment which has seen inflation hitting hundreds of thousands as illustrated in figure 2 (below). A bond market cannot exist in such a hyperinflationary environment (Fischer, 1975).Most investors in Zimbabwe prefer equities and property investments over bonds because of the yields on bonds, particularly government bonds, are low and unattractive. Most of the previous bond issues by the Government of Zimbabwe were 'plain vanilla' bonds and as such they are vulnerable to inflation. In terms of improving the features on the bonds in an inflationary environment, bonds should be linked (indexed) to inflation (Valle, 2000; Fischer, 1975). In general, when inflation is above the nominal amounts required to give monetary freedom and investing incentive, it is regarded as negative, particularly because in current economic theory, inflation begets further inflationary expectations (Beja, 1979).

The Fisher equation predicts a close relationship between inflation and the rate of return on Treasury Bills (Fischer, 1975). This is clearly shown in the graph above (figure 2), which plots both the TB rate and the inflation time series on the same set of axes. Both series tend to move together, which is consistent with the statement that inflation is a significant force determining the nominal rate of interest (Feller, 1951). The surveys carried out also confirmed that the main factor contributing to the volatility of short term interest rates was inflation. Inflationary pressures also increase uncertainty in the pricing of long term securities (Obi, Dubihlela & Choi, 2011). The nominal interest rates on government issued bonds were less than the rate of inflation (as illustrated in figure 2 above), leading to a wealth loss to the bond investors. Interest rates volatility and bond prices have an inverse relationship, such that the prices of existing bonds move up as market interest rate move down.

Figure 2: Inflation Rate and the TB Rate (1991-2006)

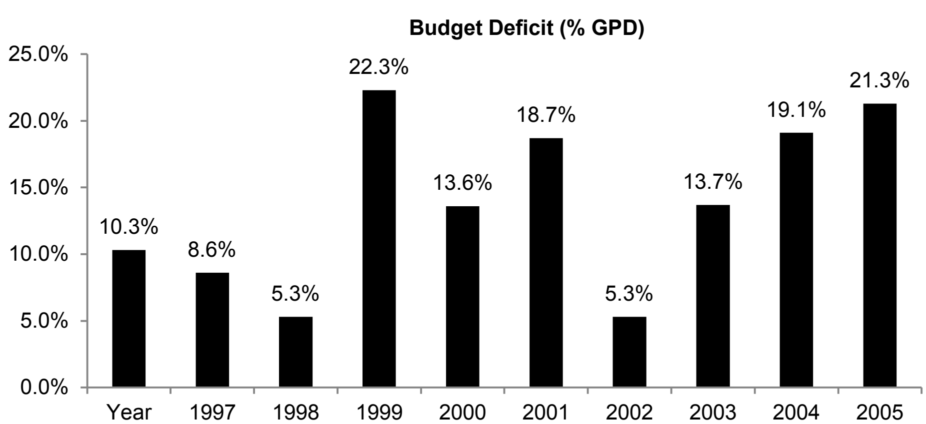


Source: Reserve Bank of Zimbabwe 2007 – illustrates the comparative trends of the average inflation rate and the Treasury bill rate over a 15 year period to 2006. Inflation rate is shown to be consistently above fixed term investment rates; a trend that discourages savings and erodes treasury bills.

Government budget deficits represent the excess of government expenditures over revenue collections. While the size of the budget deficit may not matter, its quality and financing mechanism, however, have important implications for inflation, interest rates and other macroeconomic variables (Obi, Dubihlela & Choi, 2011). The following graph (Figure 3, below) shows the extreme deficit that was experienced in the year 2000; indicating the start of the ominous economic collapse. From then onwards, the budget deficit continued to increase as the economy also continued to hit its bottom levels. The farming sector together with the manufacturing sector continued to be depressed hitting their lowest levels in the year 2008.

The maturity structure of government debt can affect both the costs and risks of using financial instruments, prompting the central bank to issue bonds whose maturity mirrors the maturity structure of short-term current and long-term capital expenditures. The absence of a contractual savings sector and mutual funds with sufficiently long investment horizons may also limit the ability of the government to extend the maturity structure. To some extent, the length of the maturity structure can be viewed as a measure of the degree of market development

Figure 3: Budget Deficit (1997-2006)



Source: Reserve Bank of Zimbabwe (2007) - The above figure represents Zimbabwe's fiscal deficits that shot beyond 10% of GDP over the last decade, peaking at 22% in 2000

CONCLUDING COMMENTS

The goal of the paper was to present an assessment of the viability of the securities market development for an economy whose financial sector continues to grapple under inflationary pressure. The study confirmed that the securities markets in Zimbabwe are below what can be expected, given the economic and institutional fundamentals. In particular, the shortfall in domestic stock market activity (market capitalization, trading, and capital raising) and other factors including per capita income, macroeconomic policies, the size of the economy, and measures of the legal and institutional environment.

The findings confirm that a country with sovereign risk, high inflation and an unstable currency will find it difficult to develop its domestic bond market. Increasing uncertainty discourages investment and saving; reducing drastically all forms of investment, and particularly foreign direct investment (FDI). The study also found that savings constraint is a key impediment to domestic bond market development. Poor liquidity is causing financial market deepening, resulting in a low level of financial intermediation by the banks. The increasing of rates by the central bank is just an attempt to control inflation which has a strong bearing on bond prices. It is follows that a rise in the short-term interest rates prompts a subsequent increase in the long-term bond interest rates too.

The results show that a confluence of factors is critical for the development of domestic bond markets in such inflationary markets. The structure of the economy, investment profile, legal environment, size of the banking sector, and the level of economic development are pre-requisites for a viable capital market. Because commercial banks hold more than half of the outstanding domestic debt, expansion has had a significant negative impact on private sector lending. The nonbank sector plays a limited role, given a relatively underdeveloped institutional investment sector in Zimbabwe. Specifically, a robust financial services sector that is free from political interference and operating on market principles is important for the development of a viable bond market. This is not the case with the Zimbabwean political economy. Ravaging or runaway inflation decrees the level of prevailing interest rates. The paper provides some policy implications as enlisted in the following section.

It is imperative to emphasize the key steps in designing country-specific financial market reforms going forward, and there should be a determination from the monetary authorities to sustain an active domestic bond market for private sector securities as well. Policy implications include increased efforts to strengthen the investment environment and the need for a regional integrative approach to bond market development. Monetary authorities need to take into account the intrinsic characteristics of Zimbabwe (such as small market size, governance dilemmas, lack of risk diversification opportunities, presence of weak currencies, and the prevalence of systemic risk), and how these features limit the scope for developing deep domestic capital markets. The reforms must be couched within a broader vision of financial development in the context of international financial integration, with the view of holding inflation at sustainable levels. This view therefore calls for a more varied reform agenda that promotes market development and an investor friend environment. A one-size-fits-all political approach is destined to fail.

The findings in this study should of course be taken with circumspection. The limitations of bond market data, as well as their aggregate nature, do not allow for a more elaborate empirical approach. It would be useful to use firm-level debt data on the source of domestic external finance of firms, to see how firms with greater reliance on securitized debt fare better after. Firm-level data would also help to account for firm size, particularly since larger firms tend to rely on debt finance. It is possible that the variables used are too general and fail to capture specific aspects of the institutional and regulatory framework that are particularly relevant for bond market development. While we discussed different factors that may explain our results, we kept the discussion at a general level and have not evaluated our hypotheses empirically. Thus, we believe that our conclusions should remain tentative and that further empirical research is needed to further interrogate the various impediments of capital market development in Zimbabwe.

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BIOGRAPHY

Dennis Sibanda is a lecturer at the Vaal University of Technology, Portgieter Boulevard, Vanderbijlpark, 1900, South Africa. Email: dennissi@vut.ac.za. Address: 11 Dick King Street, SE 6, Vanderbijlpark, 1900; South Africa

Job Dubihlela is a former banker turned academic. He is a lecturer at the Vaal University of Technology, Portgieter Boulevard, Vanderbijlpark, 1900, South Africa Email: job@vut.ac.za. Address: 11 Dick King Street, SE 6, Vanderbijlpark, 1900; South Africa Tel:+27(16) 9305062; +27(16) 950 9145; Mobile: +27 83 985 5136; +27 79 117 8514

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