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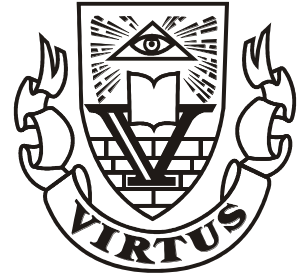

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SOUND AND CONSUMER BUYING BEHAVIOUR: DO APPAREL RETAILERS TAKE NOTE OF THE EFFECT OF SOUND ON BUYING BEHAVIOUR

C.E. Nell*, M.C. Cant**

Abstract

The main aim of this study was to investigate the influence of sound on consumers buying behaviour in apparel retail stores. The type of research design used in this study was exploratory in nature, making use of a qualitative approach and a communicative technique of focus group interviews and naïve sketches. The data gathered was analysed by means of Tesch's inductive descriptive coding technique, better known as thematic analysis. It was found that sound has the ability to influence consumers in either a subconscious or a conscious way. This has a direct influence on the amount of time that consumers are willing to spend in-store and ultimately influencing their buying decisions and behaviour in either a positive or a negative way.

Keywords: Store Atmospherics; Senses; Sound; Consumer Behaviour; Approach Behaviour; Avoidance Behaviour

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1 Introduction and objectives

Over the past few decades, the retail industry has grown exponentially, resulting in a highly intensive and competitive market (Wanninayake & Randiwela, 2007:2; Liaw, 2007:1). Retailers can no longer rely only on their products, prices, promotions and place in order to attract customers and influence their shopping behaviour (Liaw, 2007:1; Wanninayake & Randiwela, 2007:5). It has become crucial for retailers to optimally utilize the store space in order to differentiate themselves from competitors in the retail market and in the process also to ensure that the consumers have a pleasant shopping experience.

Spies, Hesse and Loesch (1997:1) maintain that customers find some stores more attractive to shop in than others irrespective of the merchandise on offer. This attractiveness of stores have a direct correlation to the "feeling" experienced in the store – some stores impact consumers in a positive way while others provoke a feeling of irritation or discomfort. For this reason it is essential for retail stores to create a positive in-store environment, as a positive mood can easily increase the consumers' time and money spent (Spies *et al.*, 1997:1).

In order to create a positive and pleasurable in-store environment various elements such as music, scent, lighting, colours and flooring can be used by which shoppers are excited (Berman & Evans, 1998:552). According to ACP Connections ([n.d]:1), 83% of all in-store communications appeal only to one sense, namely the vision or the eyes , and only 17% are left to cater for the other four senses. The study further point out that 75% of consumers' day-to-day emotions are influenced by what they smell, and there is a 65% chance of a customer's mood being changed when exposed to positive sounds. It was found that most retailers focus primarily on sight as a sense to attract consumers into their stores, but enhances the consumers' shopping experience when sound, smell and touch are also added to the in-store shopping environment (ACP Connections, [n.d.]:1).

This study aimed to obtain a holistic view of store atmospherics, with a specific focus on sound, which forms part of the total retail shopping experience. A consumer-centred response approach was followed in this study. The study could benefit apparel retailers as the influence and impact of sound on consumers' buying behaviour was uncovered. The same findings of the study can be extrapolated to apply to retailers worldwide with only minor adjustments and adaptations in order to meet local conditions and customs.

The purpose of this study was to investigate the influence of sound on consumers' buying behaviour in apparel retail stores in Tshwane. This study aims to investigate, within the context of Tshwane:

- the influence of sound on consumers' buying behaviour.

The following section gives an overview of store atmospherics and what it is, the component sound, and consumers' buying behaviour. The empirical findings and the discussion of the findings appear in the latter part of the paper.

2 Literature review

2.1 Store atmospherics

The aim and objective behind any retail store's design is to enhance consumer spending, to differentiate it from competitors and to enhance in-store traffic (Pradhan, 2007:347). A method to enhance this shopping experience and generating an increase in consumer traffic is through the use of store "atmospherics" – a term first introduced by Phillip Kotler (Pradhan, 2007:347). Store atmospherics is a word used by retailers to describe elements such as lighting, colour, music, aromas and so on and which is used to appeal the five human senses and in so doing contribute to the overall in-store environment or experience (Bell & Ternus, 2006:21). Bell and Ternus (2006:21) state that atmospheric elements have the ability to influence consumers' feelings about being in and staying in a retail store and that the longer consumers stay in a store, the more likely it is that they will buy.

The term "atmosphere" or "atmospherics" can be defined as the physical characteristics of a store that is used to develop an image in order to attract consumers (Berman & Evans, 2010:508). Liu and Jang (2009:495) defined atmospherics as "... the conscious designing of space to produce specific emotional effects in buyers that enhance their purchase probability". Levy, Weitz, and Beitelspacher (2012:490) describe atmospherics as the design of a store environment by making use of the five human senses. They indicate that more retail stores have come to realise that it is very beneficial to develop atmospheric elements that complement other aspects of the store, such as the store design and merchandise (Levy *et al.*, 2012:490). For the purpose of this study, the definition of store atmospherics proposed by Kotler is used as the basis for the discussion of this topic. Kotler (2001:50) defines atmospherics "…as the designing of a buying environment in which specific buying emotions are created through the use of the senses (sight, sound, scent and touch) in order to enhance the consumer's likelihood of purchasing."

A retailer's image in the market is greatly influenced by the atmosphere prevailing in the store – the psychological feeling evoked within consumers the moment they enter a store (Berman & Evans, 2010:508). Berman and Evans (2010:508) as well as Bell and Ternus (2006:36) maintain that a store's atmosphere has the ability to influence consumers' shopping experience and satisfaction, the physical time spent browsing and evaluating the merchandise in the store, the eagerness of consumers to communicate with store personnel and to make use of store facilities such as dressing rooms, the willingness to spend more money than originally planned and the possibility of future patronage. These elements do not only contribute to the overall image of the store, but can also be used as an effective marketing tool to differentiate one store from other stores/competitors, to effectively communicate with their consumers and to attract consumers' attention (Kotler, 2001:50).

It can therefore be inferred that the atmosphere in a retail store is essential and will often determine whether or not consumers are prepared to spend more time browsing in a store. Different atmospheric elements can tactically be used to target specific consumers (Gupta & Randhawa, 2008:225). For the purpose of this study the store atmospheric element focused on and the importance thereof is sound.

2.2 Sound

Sound can be described as a specific feeling that is produced by the stimulation of the hearing organs through vibrations sent out through the air or any other medium, such as the sound of music (Dictionary.com, 2012). Kotler (2001:51) has classified sound in a retail sense as the volume or pitch of music that retailers use in order to create an appealing atmosphere. Hultén et al. (2009:67) state that "... sound affects our mood and psychological state, alerts us to danger, and promotes peace of mind for the soul". Sound has always been very important in society for both individuals as well as organisations. This is because people attach certain meanings to different types of sounds and music genres. This can be regarded as an important source of motivation and information in relation to making an association with specific organisations, stores, brands or products (Gobé, 2009:73).

Sound plays an important role in the retail environment not only in creating a pleasant in-store atmosphere, but also in communicating with consumers (Yalch & Spangenberg, 2000:140). Retailers can use sound in a number of ways:

- It can be implemented in mass marketing actions in order to communicate messages about an organisation, its products and brands, and it can also be used as an effective way of creating awareness (Hultén et al., 2009:67; Krishna, 2010:137).
- It can be used to create or activate specific emotions or feelings within consumers (Hultén et al. 2009:74).
- It can be used to strengthen the identity and image of a specific retail store, brand or product (Ogden-Barnes & Barclay, [n.d.]:15).
- It can be used to create an effective and memorable sound experience through certain voices, jingles and music genres which can be regarded as a signature sound that characterises a particular retailer, brand or product (Daye & VanAuken, 2010:1).

It is important that retailers that are making use of sounds in advertisements or in their stores should realise that consumers react to these sounds with different feelings towards different types of sounds and specifically in the case of music genres and voices (Gobé, 2009:73). Retailers should therefore ensure that the type of music or voices used should match both the type of consumer as the style of merchandise offered (Morgan, 2008:170). Organisations should also be aware that sounds with high frequencies are normally the first sound that consumers notice. However, the type of sound can have a subconscious effect on the consumer. For instance, a continuous, low-frequency sound may have an irritating effect on the consumer and when it stops consumers may experience a huge relief (Hultén et al., 2009:68). It is also a fact that some sounds can be very disturbing to consumers resulting in them rather leaving a store than be exposed to it. From this it is clear that sound is an important element that retailers should carefully consider, as it may play a vital role in the consumers' shopping experience (Krishna, 2010:137).

Kotler (2001:51) is of the opinion that music is a very important element that retailers can use in order to contribute to the overall atmosphere generated in the store. Music as an element in the creation of store atmospherics is discussed next.

2.3 Music

The role and importance of music in the establishing of store atmospherics cannot be negated. Much like colour and lighting, music can either add to or take away from a retailer's overall store atmosphere. However, unlike other atmospheric cues, music can easily be altered and changed to either create a different in-store atmosphere or to reach different consumers (Levy et al., 2012:491). This can be done in a number of ways:

- Music can be used to categorize areas in a store, for example music can be used to distinguish women's wear from children's wear (Levy et al., 2012:491).
- Using various music genres to affect the behaviour of consumers, to direct and control the pace of in-store traffic, to create a specific image and to attract consumers' attention (Levy et al., 2012:491). Classical music is for example played in many toy stores as the parents are the buyers of the products and not the children, even though the children are the ones using them. Music can be used to guide consumers in a store and to create a sense of belonging (Gobé, 2009:76).

From this brief discussion it is clear that music has the ability to help create an atmosphere that attracts different consumer groups, but then it must be ensured that the type of music is suitable for the consumer group. Playing music that does not appeal to or attract different consumer groups is as bad as using the wrong colours, lighting that is either too low or too dark or temperature that is either too cold or too hot (Ogden-Barnes & Barclay, [n.d.]). Hultén et al. (2009:77) explain that if a retail store can manage to create the right in-store atmosphere through the use of music, the chance that consumers will be more stimulated and keen to purchase is much higher. Music can therefore positively affect their behaviour in terms of:

- time perception – music with a slow tempo in contrast with music with a fast tempo increases emotional responses and makes consumers perceive the waiting time to be shorter, thus resulting in staying longer in the store (Krishna, 2010:149)
- spending more money than originally planned (Ogden-Barnes & Barclay, [n.d.]:15); and
- positive word of mouth – recommending the store to others (Ogden-Barnes & Barclay, [n.d.]:15).

Music therefore has a direct effect on the speed of shopping, the amount of time spent in the store, the amount of time consumers are willing to spend waiting for things, as well as the amount of money they are prepared to spend (Krishna, 2010:77).

2.4 Consumer emotions and buying behaviour

According to Mehrabian and Russell (1974), in-store environmental stimuli such as the human sense, sight, have a direct influence on consumers' emotions which further results in a behavioural response (Jang & Namkung, 2009:451; Kang et al., 2011:2). From the literature, it can be seen that the human senses do have an influence on consumers' emotions. The moment that consumers see a specific picture or object, past memories are immediately recalled and re-experienced and therefore specific emotions, such as happy or sad, is brought to the consumers' mind (Hultén et al., 2009:10, 57, 115).

Liao and Liaw ([n.d.]:2) define emotions as the "... oral expression of feelings and as a personal, subjective psychological state". A store's environment can elicit three types of emotions. The first emotion is pleasure, which can be described as an effectual reaction, which will indicate whether consumers find the environment enjoyable or not (Jang & Namkung, 2009:451). The second emotion is arousal, which indicates how much the environment stimulates the consumers. The third emotion is dominance which is concerned with whether consumers feel in control or not in the environment. Jang and Namkung (2009:451), however, indicate that dominance has a non-significant effect on behaviour.

It is likely that certain positive emotional reactions caused by the sense, sight, will result in increased consumer spending, but it will highly depend on the type of in-store atmosphere that is created (Kotler, 2001:54). Therefore, it can be inferred that emotional reactions (pleasure, arousal and dominance) will most likely have an influence on consumers' behavioural responses. Furthermore, Mehrabian and Russell (1974) defined the emotional state and behavioural responses

of consumers' to an environment as approach (positive) and avoidance (negative). Approach behaviours include all positive behavioural intentions that are influenced by an environment such as good lighting, pleasant music and attractive smells, whereas avoidance behaviours are the opposite which include all the negative behavioural intentions (Kang et al., 2011:3).

It can be deduced from the above literature outline that in-store atmospheric elements, and specifically sound, do have an influence on the emotions of consumers and will impact and influence their buying behaviour. The next section deals with the research methodology and the findings of the research.

3 Research Methodology

Qualitative research was used for this study, as a detailed explanation of *sound* and its influence on consumers' buying behaviour was needed, as well as the fact that qualitative research has the ability to discover true significance and new insights about the available data (Zikmund & Babin, 2010).

The extent to which *sound* influences consumers' buying behaviour was studied by means of exploratory research. Exploratory research is used to explore and to clarify ambiguous situations and ideas of a research problem (Zikmund and Babin, 2007:42).

Due to the exploratory nature of the study, non-probability, purposive sampling was used. Non-probability sampling is a sampling method where the samples are grouped in a process that does not give all the individuals in the population an equal chance of being selected (Tustin *et al*, 2005). Subjects in a non-probability sample are usually selected on the basis of convenience, as they are easy and/or inexpensive to reach or by the purposive personal judgment of the researcher (Hair, Bush & Ortinau, 2009:312). In purposive sampling, the researcher samples with a purpose in mind (Zikmund & Babin, 2010).

The inclusion criteria for the purposive sampling for this research study were as follows:

- Any male or female older than 18 years
- Any person who bought at apparel retail stores
- Any person who resided in the Tshwane region of Gauteng
- Any person that could understand, speak and write English

Data was collected by means of a communicative technique of interviews, and the selected methods were focus group interviews and naïve sketches. Focus group interviews which are an unstructured, free flowing interview with small groups of people, generally eight to twelve participants and naive sketches which are an open-ended questionnaire that asks participants questions regarding the specific topic (Hair et al., 2009:161), was used to collect data from 16 participants (eight participants in each focus group and naive sketch). Due to this, two forms of data was received and compared with one another in order to gain maximum data from each participant.

The focus groups were based on the use of visual material in order to create an atmosphere. The photographs were taken of the atmospheric themes implemented by two stores in the Tshwane region and they were included in both the naïve sketches and the focus groups. The participants were asked two questions (the same questions in both the naive sketch and focus group interview) which were derived from the research objectives. The questions are as follow:

1. What do you understand about a clothing retail store's atmosphere?
2. When you walk into a clothing store, what is the influence of sound (what you can hear – music) used in-store on your buying behaviour?

Thematic analysis was used, since the required data for this research study was contextual in nature. Thematic analysis is a qualitative research process that involves intensive searching through data to identify any possible patterns, known as themes and categories that might occur more than once (Tesch, 1990:113). It is a process that organises and describes data in detail (Braun & Clarke, 2006).

4 Results

The outcomes of the questions asked in both the focus group interviews and the naive sketches are examined in terms of three main themes and their underlying categories as outlined by Tesch's model (thematic analysis).

Theme 1: Participants display a good understanding and awareness of store atmospherics, the "general ambiance" it creates and the variety of "controllable elements" used to do so, as well as the potential it has to influence their moods and in turn their buying behaviour.

Participants identified a store's atmosphere as consisting of a variety of controllable elements, such as lighting, music, layout, decor, temperature, smell and staff attitude, all of which create the general ambience. It was highlighted that the general ambience of a store is important, as it creates a general feeling of either being welcome or not the moment a person enters a store.

The participants also indicated that store atmospherics potentially influenced their mood, and in turn their buying behaviour. In the focus group discussion, it was found that if a store managed to use the controllable elements of lighting and colours correctly, the likelihood of the participants buying increased. However, if these controllable characteristics were used incorrectly, the likelihood that participants would rather leave a store was enhanced.

Two categories emerged from the first theme and are explained below.

Category 1: A store's atmosphere consists of a variety of controllable elements, such as lighting, music, layout, decor, temperature, smell and staff attitude, all of which create the general ambience

From both the focus group interviews and naïve sketches it was clear that the participants understood the term "store atmospherics" (as defined in the literature) as the controllable elements that a store can use to create a general ambience or feeling. General ambience is defined by Dunne and Lusch (2008:457) as the "overall feeling or mood projected by a store through its aesthetic appeal to human senses". The participants indicated that a pleasant in-store environment was created through attention to detail. They further indicated that store atmospherics could be anything that affected the senses of consumers, such as sight, sound, smell and touch, and that it was important for the temperature in-store to be comfortable. They felt that it should rather be too cold than too hot.

The following quotes of the participants were taken from both the focus group interviews and naïve sketches to confirm the findings regarding the first category of controllable elements:

- "... it's mostly all controllable elements that lead to our likes, it's like the type of music that is playing in the background, the colours, the lighting, the scent that you get when you walk into the store, is something that retail can control ..."
- "The 'general ambiance' of the store created by lighting, music, layout, availability of personnel and paypoints"
- "... includes mostly all the controllable characteristics that a store utilizes in order to entice the customer and influence their moods"

Category 2: Store atmospherics potentially influenced their mood, and in turn their buying behaviour

The participants from both the focus group interviews and naïve sketches indicated that they were far less likely to stay in a store if the music was too loud, as this had a negative influence on their mood and in turn on their buying behaviour. Three quotes were taken from the focus group interviews to substantiate the above findings.

- "… far less likely to stay in a store if it is playing loud music"
- "... if the music is too loud, it will reduce my buying behaviour, if the music is pleasant and not in your face, it will probably enhance or add to me wanting to stay longer and linger longer in the store ..."
- "... if the music is too loud or not nice then I rather just leaves ..."

Theme 2: Store atmospherics speaks a "silent language" to participants, reinforcing niche/target market appeal and/or merchandise integrity/quality or lack thereof, either enticing them into or repelling them from a store.

Participants from both the focus group interviews and naïve sketches were of the opinion that store atmospherics spoke a silent language, meaning that the participants did not always recognise the atmospheric elements used in-store, but if they were unpleasant (lighting too dark) they immediately became aware of it or noticed it. It can therefore be implied that store atmospherics has a subliminal (subconscious) influence on consumers.

The participants further pointed out in both the focus group interviews and naïve sketches that store atmospherics could be context driven and therefore appeal to a specific target market or consumer group. The participants said that they would not enter some stores, because they did not feel comfortable in there and these stores did not fit in with their style and personality.

The participants also indicated that store atmospherics formed part of a store's total product and could therefore reveal something about the quality or integrity of the product and/or service offered. It is clear that the participants felt that a store that was too dark could portray an image of dirtiness and that the store was hiding something. They further emphasised the importance of the types of atmospheric elements used fitting in with the type of merchandise that the store offered. Three quotes were taken from the focus groups to illustrate the participants' views on all three categories.

Three categories emerged from the second theme and are explained below.

Category 1: Store atmospherics spoke a silent language

The participants did not always notice a specific sound or music playing in-store, but when they recognised that the type of sound or music was "out of place", they became annoyed and left the store immediately, thus affecting their buying behaviour negatively. Two quotes were taken from the focus group interviews which justify the above findings.

- "... I tend to not notice music, if it does not irritate me, or sounds, I notice it if it irritates me but if it doesn't irritate me, then no ..."
- "I think a lot of the music has got a lot to do with the subconscious because you are not walking into the store to go and listen to music and if it hits you and now the thing is, all twelve of us can walk into the same store, six will be irritated, two wouldn't even notice it and the other two that likes it, yes"

Category 2: store atmospherics could be context driven and therefore appeal to a specific target market or consumer group

Both the focus group interviews and naïve sketches revealed that the participants felt that the atmosphere of some stores was context driven and that it appealed to a specific niche or target market. When a participant did not feel comfortable in a store, sometimes due to bad lighting, they either did not enter the store or they left shortly after entering, as they did not feel welcome there.

The following two quotes of the participants were taken from both the focus group interviews and naïve sketches to validate the findings regarding the second category of context driven:

- "I mean you walk into the Disney Store, there

is a sound of sleigh bells, there is sounds of you know, Chipmunk songs and there is Disney tunes and these kinds of things and they influence how happy the kids are because that is their target audience ...”

- “When I go into a Zoot or one of these, I don’t feel welcome anymore, the atmospherics is not right, I get the feeling it’s the young people, the young people buy there and I feel that I am not welcome, but that is obviously not true, I just don’t feel like the atmosphere is right, the music is too loud, lighting is not what I like, clothes are too cluttered, so I just, you know, me, I personally like the ambience of the stores that I frequent.”

Category 3: Store atmospherics formed part of a store’s total product

It was evident from both the focus group interviews and naïve sketches that the participants felt that the types of atmospheric elements used formed part of the product and/or service offered by the store. In other words, the participants felt that the type of atmospherics used in a store should fit the type of merchandise offered. The participants further indicated that a dark store projected an image of poor quality and filthiness, whereas a store with proper lighting projected a feeling of cleanliness and good quality. It can therefore be inferred from the focus group interviews and naïve sketches that a more “elegant” store should make use of good lighting in order to emphasise the quality of the merchandise. The participants furthermore pointed out that it was important for the type of music played in a store to fit in with the merchandise and services offered, in order to contribute to the overall atmosphere of the store.

The following quotes of the participants were taken from both the focus group interviews and naïve sketches to confirm the above findings regarding the third category of store’s total product:

- “too much darkness that says, okay why? ... it’s dirty, you know, they are hiding their quality they are not proud to stand up and say something, I am just saying from a psychological perspective that is what darkness would imply”
- “Whereas you know, go to Queenspark and there is some rap or something, it’s definitely not going to make you want to buy, so it’s definitely, you have to relate it to what you are selling”
- “I think the music that stores have also have to relate to the merchandise they sell”

Theme 3: Elements of store atmospherics that move towards either extreme (for example, too hot or too cold) become salient or obtrusive to consumers, leading to discomfort and limiting or disrupting browsing time and thus lessening the chance that the product will be discovered and bought.

The participants stated that certain atmospheric elements that moved towards the extremes, for instance too loud, too dark or too hot, led to discomfort and/or irritation, which affected their spending. It was clear from both the focus group interviews and naïve sketches that the participants did not enter a store if they could see from a distance that the store was too dark. If the participants had, however, entered such a store, they would leave immediately if they recognised any unpleasant atmospheric elements.

The participants further indicated that unpleasant atmospheric elements decreased the likelihood that they would find something to buy, as the time spent on browsing was then immediately shortened. The participants stated that a store were the lighting was too dark would directly influence the amount of time spent in-store, which in turn affected their buying ability.

Two categories emerged from the second theme and are explained below.

Category 1: Atmospheric elements that moved towards the extremes, led to discomfort or irritation

The participants of both the focus group interviews and naïve sketches indicated that atmospheric elements that move towards an extreme in either direction led to irritation or discomfort and made them leave the store immediately. The participants would not enter a store if they observed from a distance that the music was too loud. Therefore, unpleasant atmospheric elements will most likely have a negative influence on the buying behaviour of consumers.

The following quotes of the participants were taken from both the focus group interviews and naïve sketches to confirm the above findings regarding the first category of elements that move to extremes:

- “... and I just couldn’t take it, he was, you know, it was too loud”
- “I don’t like loud music so I won’t go there, I would rather look for a better store”
- “... if the music is too loud, it will reduce my buying behaviour, if the music is pleasant and not in your face, it will probably enhance or add to me wanting to stay longer and linger longer in the store but it’s not a definitive, you know I will buy because of the music”
- “I don’t think that music will entice me to buy more, it will definitely, if it is not to my liking, it will rush me to get out of there and to limit the time in the shop”
- “[lighting] influences whether you go into a shop or not, I mean a dark sort of dingy looking shop, you are not going to want to enter into so it starts right at the outside of an appeal”

Category 2: Unpleasant atmospheric elements decreased the likelihood that they would find something to buy

The participants in both the focus group interviews and naïve sketches explained that any unpleasant atmospheric element detected in the store, whether it was too loud or too dark, had a direct influence on the amount of time that they spent browsing in the store, which ultimately influenced the likelihood of purchasing something, most probably in a negative way. The participants made it clear that

they would not tolerate any unpleasant atmospheric elements in-store and would therefore leave the store immediately. This would decrease the likelihood of buying something.

The following quotes of the participants were taken from both the focus group interviews and naïve sketches to validate the above findings regarding the second category of unpleasant atmospherics:

- "... will influence the time spent browsing and will influence whether I will try stuff on or not"
- "... but if the lighting is not, you know, to my appeal, then I am just going to spend less time there"
- "... I think it greatly has an impact on how long you spend in a store"
- "... I am not going to stay there and spend time there"

5 Conclusion

Sound (music or noise) was found to have a profound effect on the amount of time that the participants spent in-store. They were far less likely to stay in a store if the music was too loud, and this directly influenced their buying behaviour. Furthermore, participants indicated that they would not enter a store if they could observe (hear) from a distance that the music was too loud, as it made them feel unwelcome and would rather leave. Feeling comfortable at all times while shopping in a specific store was critical to the participants and as soon as they noticed that the music was too loud according to their preference, they were inclined to leave the store immediately, or as soon as possible.

The participants also indicated that they did not always notice sounds (music, noise) in-store. This therefore implies that sound (music) can have a subtle influence on consumers, as they do not always notice it. However, the moment that consumers do recognise any form of sound (music, noise or radio) in-store that they do not like, they will become uneasy (irritated) and possibly leave the store. This has a negative influence on their buying behaviour. Additionally, if the in-store music is pleasant and "not in your face", it will most probably enhance or add to the total time spent in-store, which might have a positive influence on the buying behaviour of consumers (making them inclined to stay longer, thus increasing the likelihood of purchasing).

In summary, it was established that sound can influence consumers' buying behaviour (in Tshwane) in a positive or a negative way. A positive influence means that the time that consumers spend in-store is increased, which can also increase the likelihood of buying more. A negative influence means that consumers will either not enter a store or will reduce the time spent in-store, thus lessening the possibility of buying. The reasons for the positive and negative influences that sound have on consumers' buying behaviour are as follows:

- Consumers will not enter a store if they can hear from a distance that the music is too loud. This has a negative influence on their buying behaviour.
- Consumers will leave the store immediately if they notice or recognise an annoying sound or music that is too loud, as they easily become irritated. This has a negative influence on their buying behaviour.
- Consumers will leave the store immediately if a radio station is playing in the background, as they perceive a radio station as being highly annoying. This has a negative influence on their buying behaviour.
- Consumers might stay longer in-store if pleasant music is playing, thus having a positive influence on their buying behaviour.

From this, it is clear that the amount of time spent in-store is directly influenced by the sound (music or noise) in-store, which can have a direct influence on consumers' buying behaviour. Therefore it is critical that apparel retailers should give attention to the use of proper sounds in-store in order to ensure that the browsing time of consumers is increased.

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RETHINKING THE EROSIONAL EFFECT OF INDIRECT TAXES ON INDIVIDUAL INCOME

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Abstract

This paper examines the erosional effect of indirect taxes on individual incomes of South African citizens. A focus on taxation and the pervasion of indirect taxation in particular has become important given growing income inequality, unemployment and poverty amongst South Africans. The methodological approach utilised in this paper is rooted in reviews and use of hypothetical salaries to assess the erosional effect of indirect taxation on such salaries. The paper finds that although richer individuals may pay greater indirect taxes than poorer individuals; as a proportion of income however, poorer individuals spend higher proportion of their income on indirect taxes than richer individuals. This connotes therefore the lack of desired progressivity that should be implicit in South African indirect tax system. South Africa is among countries with the highest income inequality in the world. The implication of this research finding is that indirect taxes may exacerbate income inequality and work against the government vision of "better life for all" and in particular worsen the state of the poor class. The paper concludes that achieving effective reduction of income inequality and economic transformation in South Africa would require exempting individuals below certain threshold of income from paying some indirect taxes.

Keywords: Indirect Taxation; Poverty Alleviation; Economic Transformation; Income Inequality; South Africa

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1 Introduction

Julian May provides a laconic analysis of poverty and inequality trends in South Africa emerging mainly from the Carnegie inquiries. The first of such inquiries was in 1922 with a focus on the state of poor whites. After 1994 both Carnegie and the Labour and Development Research Unit (SALDRU) poverty reports on South African have an interest on poverty manifestations and impact on all races (May 1998). While May (1998) and Hoogeveen and Özler 2005) reports presents contradicting poverty calculations, they all however agree that poverty has always been skewed against black South Africans. In the mid1990s (1994-1995) majority of South Africans (58 to 61%) who were poor were blacks (55% to 68%) followed by Coloureds (38%), Indians (5%) and Whites (1%). Although more than 70% of the world's population are presumed to live in poverty (Anderson et al, 1991; Mashigo, 2006), the Gini coefficient which has risen from 0.55 to 0.62 between 1993 and 2008 pitching South Africa among the poorest in the world (Coetzer, 2013).

Both poverty-extreme poverty and inequality escalated after 1994, between 1995 to 2000 due to the recession, and thereafter due to stagnant economic growth and poor investment, among other factors. The overall inequality rose sharply fuelled by rising inequality among blacks with an overall Gini coefficient for expenditure rising to 0.62 and thereby turning South African one of the most unequal societies in the world (Hoogeveen and Özler 2005). Unemployment too has risen steadily after 1994, though highest levels are in the rural areas, levels of between 30-41% were recorded between 1998 and 2005 on the basis of the broad definition (Gandhi-Kingdon & Knight 2001; Klasen & Woolard, 2008). These unemployment rates catapults South Africa to be at high-end among developing countries, among the highest in the world and the highest measured open unemployment in Sub-Sahara Africa (Klasen & Woolard, 2008).

The social contract which legitimises state authority posits that society cedes legal rights like guardianship for attainment of social justice, a working economy, security, adequate health, among others, for preservation by the state (Lubchenco,

1998). To legitimise and guarantee this obligatory role the state creates enabling policies and raises resources through a taxation system (John, 2006;). While many scholars give a cursory review to the effect of taxation systems, especially the indirect taxation on poverty and inequality, a few provide an intense critique of its effect on the "true value" of incomes and effect on individual savings (Koch, et al 2005; Aron & Muellbauer, 2000). Favourable taxation systems, equitable and progressive tax though every state's choice, it is never the less difficult to implement and attain. Where pressing challenges like unemployment, inequality and hyperinflation persists many states gravitate towards, among others, welfare state trajectory to provide a safety net, introduce regressive tax measures and potential for high indirect tax incidents (Caragata, 1998).

The question that underpins this paper therefore is: how do indirect taxes affect the disposable income of low income earners? Consequently the aim of this paper is to use a hypothetical illustration to buttress literature on the effect of indirect taxes on low income earners.

The paper is organised as follows: the next section after the introduction presents an overview of indirect taxation; section three presents a review of literature on the regressive and erosional effect of indirect taxes on income. Section four presents the methodology and a hypothetical illustration whilst section five draws conclusion.

2 Overview of the Objectives of Indirect Taxation

Governments all over the world are inundated with many national obligations and functions that require financial capacity. These functions include *inter alia* national defence, maintenance of law enforcement personnel, healthcare, roads, education and poverty alleviation. These obligations are financed by different forms of taxation including indirect taxation, which are those levied at rates regardless of taxpayers' characteristics (Conklin, 1991)**.** Experts acquiesce that the core objectives of indirect taxation comprise fiscal revenue generation, equity, and efficiency (Atkinson and Stiglitz, 1972; Bovenberg, 1987; Burgess & Stern, 1993)**.** Indirect taxes are one of the important avenues for raising short-term revenue by governments (Bovenberg, 1987). According to PriceWaterHouseCoopers (2007) indirect taxes constitute a major source of government revenue globally, and the seeming reliance on indirect taxation for raising revenue is growing as many nations give preference to a more-consumption oriented tax policies (see also, Creedy and McDonald· 1992; Ken Yan et.al, 2010). For instance in South Africa, indirect tax revenue constitutes a significant portion of total tax revenue and value added tax (VAT) in particular is acclaimed by the National Treasury as a stable source of revenue PriceWaterHouseCoopers (2007). Regarding the equity objective; it is argued that since equity principle of taxation considers people's ability to pay, indirect taxation is therefore considered as satisfying the objective of equity. This is because the taxpayer pays indirect tax according to his/her consumption ability which thus has an element of equity. More governments have continued to move toward indirect taxation; for instance in 2009, the Jamaican Government adopted indirect taxation and the Caribean Policy and Research Institute (CaPRI) lauded this indirect tax move as equitable (The Gleaner, 2009). Furthermore indirect taxes seem to satisfy the equity objective given that luxury goods and services are taxed higher to such extent that only the rich pays such higher indirect taxes as they consume related goods and services, whereas the convenient goods and services may have lower rates that the low income class can afford to pay. However there are growing arguments that indirect taxation may be flawed in terms of equity objective; this argument touches on the crux of this article and shall be considered in the later part of this article. On the other hand, indirect taxation is said to address the efficiency objective more than direct taxation (Conklin, 1991). This is because whilst indirect taxation assists in raising sufficient government revenue, it does not create adverse distortions such as reduction in individual work incentives. Hence a tax expert – Ernst & Young (2012, p.1) comment that "the economic efficiency of indirect taxes, is encouraging many countries to increasingly rely on consumption taxes, both by raising headline rates and by expanding their tax bases".

Nonetheless it is important to balance the need for increased fiscal revenue and the other objectives – equity and efficiency (Bovenberg, 1987; Burgess & Stern, 1993). An overt implication of neglecting this balance may be that if increased revenue objective is made to dominate the other objectives, these (other objectives) may be suffocated to the detriment of the common citizens –the very low income group whom the tax system is supposed to carter for. Thus the impact of indirect taxation on the standard of living has received growing attention by scholars (Aasness et al., 2002). Hence scholars have presented argument against indirect taxation in developing countries if desired growth must be realised (Bird, 1987, 2010) and these poverty and growth implications of indirect tax arguments have relevance for Africa –particularly South Africa that is in dire need for pro-poor economic policies toward economic transformation and poverty alleviation. Thus the erosional and poverty implication of indirect taxation constitutes the core aim of this article and shall be discussed in the later part of this article.

3 Regressive & Erosional Effect of Indirect Taxation on Income

Although a much acclaimed objective of indirect taxation is to enhance progressivity in taxation (Deaton, 1977; Boadway & Pestieau, 2003); but extant literature does suggest it is fraught with regressivity and hence erosional. The regressive nature of indirect taxation may be dysfunctional and disadvantageous in societies battling with income inequality. In their study on regressive nature of indirect taxation in five European countries, Decoster, et al., (2010) conclude that indirect taxes are regressive especially with respect to disposable income (see also, UK office of National Statistics, 2011), Matsaganis & Leventi (2011). A cause for concern is the erosional implication of the regressive nature of indirect tax on disposal income, with emphasis on the burden on low income group of society (Tait, 1991; Parliament of Australia, 1999). If the low income earners' disposable income is eroded due to indirect taxation, there is the tendency that this erosion might trigger higher level of poverty in the families of low income earners as these might not be able to meet the basic needs of immediate and extended families. Given that the rich and poor pay the same rate on some commodities, this has the implication of stretching the income disparity between the rich and poor. In their conclusion on whether indirect taxes are regressive, Figari and Paulus (2012, p.28) state:

Looking at the redistributive role of indirect taxes, expressed by the increase in inequality indices when indirect taxes are subtracted from disposable income, we can conclude that indirect taxes are a regressive form of taxation with respect to income.

They further point out that poorer workers spend a larger percentage of their disposal income on indirect taxes when compared to rich workers (Figari and Paulus, 2012). Even where certain goods are VAT exempt, notwithstanding, Figari and Paulus (2012) argue that exemption of certain goods from VAT is not an effective redistribution means as such exemptions are not only meant for the benefit of poorer citizens. Thus Crawford et al. (2010) maintain that a uniform VAT rate is regressive. Albeit the distributional claims Cremer, et al (2001) of indirect taxation, Kakwani (1977) provides strong evidence that when the distributional effect is completely broken down, all commodity tax becomes regressive. This therefore may mean that the much rhetorical claims of progressivity in indirect taxation and distributional implication on the poor may be somewhat weak and thus may be failing to protect the poor from the erosional impact of indirect taxation. The implication therefore is that indirect taxation may disadvantage the poor (Fourie and Owen, 1993). They stress vehemently that indirect tax such as value added tax is regressive and laments its implications on economic justice and poverty as the poor carries greater burden of indirect taxation (see e.g. Fourie and Owen, 1993, p. 308; Deloitte & Touche, 2012).

The chief disadvantage of indirect taxes on low income earners is the erosion of disposable income of such workers; low income workers become poorer more than middle or higher class after paying indirect taxes, consequently such plummeted condition of disposable income of poor workers limits their ability to meet the economic needs of immediate families. Furthermore, the poor workers are accordingly deprived of present and/or future capacity to save and invest. Therefore indirect taxes can be said to be furthering income inequality and poverty. A recent research by the UK national office of Statistics as reported in The Telegraph (2013) lament that the poor bear greater grunt of indirect taxes such as VAT, with high erosion of disposable income amongst the poor workers, and thus makes the poor poorer. The erosional effect of indirect taxes requires important attention and rethinking in South Africa given extensive income inequality and poverty in the Republic. The next section presents a hypothetical illustration of erosional effect of indirect taxes on disposable income of low and medium and high income earners.

4 Methodology

The methodological choices for this study are a hypothetical illustration that shows the erosional effect of indirect taxation on disposable income of workers. The authors borrowed percentage of tax paid on indirect taxes from the country study of Casale (2009). In the country study of indirect taxation in South Africa, Casale (2009) limited indirect taxation to VAT, excise duties, and fuel levy; similarly in our attempt to present a lucid illustration, we also limit our example to the three indirect taxes as used by Casale (2009) which are VAT, excise duties, and fuel. Whilst Casale (2009) explored the impact of indirect taxation on gender equity; we are interested on the erosional effect of indirect taxation on disposable income of workers –particularly on the low income workers. Except for the percentage of indirect tax borrowed from Casale (2009), all other figures in Rand are hypothetical. Hypothetical illustrations has been widely used in research to offer insights to new knowledge and to galvanise research inquisition toward applying the illustration to real data research or to real world application, (example is the use of illustration to suggest a new environmental budgeting method) by Burritt and Schaltegger (2001), which is popular today in environmental budgeting.

In consonant with popular views, Write (1979; Slocum and Mathews, 1970) identify three main groups of social class – lower class, middle class and upper class. We therefore concur with the three levels of social class theories, and proceed below to assign hypothetical salaries and pay as you earn taxation. The balance, being the disposable income is further

subjected to indirect taxation deductions, and as said earlier above, we try to keep the illustration succinct by adopting Casale (2009) three types of indirect taxation – VAT, excise tax, and fuel tax. Table below shows the illustration:

Table 1. Erosional Effect of Indirect Taxation on Disposable Income

Income Categories	*Lower class income group*	*Middle class income group*	*Higher Class Income Group*
Taxable income after allowances and deductions	***6 000***	***15 000***	***60 000***
PAYE	***106***	***1 779***	***17 131***
Disposable income	***5 894***	***13 221***	***42 869***
Expenditure attracting indirect taxes	**1500**	**3 000**	**9 000**
Indirect Taxes	**140**	**280**	**842.4**
% of income paid as indirect taxes	***2.4%***	***2.1%***	***1.96%***

Source: authors' hypothetical Illustration
Indirect taxes: (VAT, excise tax, and petrol tax)

Monthly tax deductions (PAYE) are estimated from SARS' March 2013 to February 2014 monthly tax deduction table (SARS, 2013). Using Casale (2009) total indirect tax (VAT, excise, and petrol) paid by families where only the male is the breadwinner which according to Casale (2009) is 9.36%.

Low income: expenditure attracting indirect tax: R1500 x 0.0936 = Total indirect tax of R140

Therefore percentage indirect tax on income = R140/*5894* = 0.0233;

Medium income: expenditure attracting indirect tax: R3000 x 0.0936 = Total indirect tax of R280

Therefore percentage of indirect tax on income = R280.8/*13221*= 0.021;

High income: expenditure attracting indirect tax: R9000 x 0.0936 = Total indirect tax of R842.4

Therefore percentage of indirect tax on income = R842.4/*14869*= 0.0196

5 Conclusion

We set out to illustrate the erosional effect of indirect taxes on income, specifically to highlight that indirect taxes may widen income inequality given its regressive nature. Extant literature reviewed in this paper point to the regressivity implicit in indirect taxes and how the poorer workers are disadvantaged. Using a hypothetical illustration, we attempted to buttress literature assertion that low income workers feel the brunt of indirect taxation more than the middle and/or high income earners. We used an empirical finding by Casale (2009) of average indirect tax paid as a percentage of expenditure by South African male bread winner families. Applying this percentage on our hypothetical expenditure we find that although high income earners pay greater indirect taxes than low income earners, an examination of the percentages indicate that low income earners pay higher proportion of their disposable income on indirect taxes more than the high income earners. This thus connotes partial lack of desired progressivity implicit in indirect taxes. The implication hence is that indirect taxes may widen income inequality. But this is not desirable as the Nation battles with measures to reduce income inequality to enhance economic transformation. It is therefore likely that indirect taxes may be fostering income inequality, and therefore deserves rethinking by tax authorities. We consequently think that achieving effective reduction of income inequality in South Africa would require exempting low income individuals below certain threshold of income from paying indirect taxes.

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A CONCEPTUAL LITERATURE ANALYSIS OF THE RELATIONSHIP BETWEEN FDI AND EXPORTS

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Abstract

The study investigates the theoretical and empirical literature framework that explains the relationship between foreign direct investment (FDI) and exports. Three prominent views explaining the causality relationship between exports and FDI were discussed and these include the FDI- led exports view, exports-led FDI view and the feedback view. FDI-led exports view mentions that exports can increase or decrease in direct response to changes in foreign direct investment inflows or outflows. The exports-led FDI view suggests that exports spur FDI whilst the feedback view says that both exports and FDI promote each other. The trend analysis between FDI and exports for Botswana as a case study was also looked into using time series annual data ranging from 1980 to 2011 obtained from World Development Indicators. The literature review framework analysis shows that the FDI-led exports view is more popular with most theoretical and empirical studies. It is against this background that the author recommends authorities to come up with policies that attract FDI into their economies in order to boost export sector for growth reasons.

Keywords: Conceptual Analysis, FDI, Exports, Growth

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1 Introduction

Majority of the studies have so far focused on the FDI-led growth and the export-led growth nexus with little focus on exclusively the FDI-exports hypothesis (Shabbir and Naveed, 2010). There are three outstanding views that explain the causality relationship between FDI and exports. These are exports-led FDI growth hypothesis, FDI-led exports growth hypothesis and the feedback hypothesis.

Proponents of the view that exports Granger cause FDI(exports-led FDI growth hypothesis) include but not limited to Tekin (2012), Zhang and Felmingham (2001), Djokoto (2012), Dash and Sharma (2011). Empirical studies which established a uni-directional causality relationship running from FDI to exports (FDI-led exports growth hypothesis) were done by Kosekahyaoglu (2006), Dasgupta (2009), Lee et al (2007), Tekin (2012), Xing (2007), Alguacil and Orts (2002), Xuan and Xing (2008), Andraz and Rodrigues (2010), Adhikary (2012), Akoto (2012), Zhang and Song (2000), among others. The feedback view whose proponents says both FDI and exports promote each other (feedback hypothesis) in the short and long run include but are not limited to Kosekahyaoglu (2006), Klasra (2011), Aizenman and Noy (2006), Zhang and Felmingham (2001), Wong and Tang (2007), Akoto (2012), Liu et al (2002) and Pfaffermayr (1994). The previous theoretical and empirical studies clearly show the absence of consensus with regard to the directional causality relationship between exports and FDI. This is clear evidence that this discussion is still inconclusive and far from over hence this study focuses on filling this gap in literature.

This current theoretical framework analysis will help policy makers to develop relevant policies to sustain FDI inflows in order to boost's exports competitiveness in the international market. If this study discovers a uni-directional causality relationship running from exports to FDI as the popular view, then policy makers would need to introduce more exports promotion strategies in order to attract more FDI inflows for economic growth purposes. If the study reveals a uni-directional causality relationship running from FDI to exports as the most popular view, then authorities would be encouraged to come up with more FDI inflows strategies so as to enhance the export sector. If the study establishes a feedback view to be the most popular view, then authorities and policy makers would be encouraged to develop other viable alternative strategies and policies to stimulate both FDI inflows and exports in order to enhance economic growth in their respective economies.

The remaining section of the research is structured as follows: Second section investigates theoretical and empirical literature review framework whilst the third section looks at Botswana as a case study in as far as the FDI-exports trends is concerned.

Section four gives concluding remarks and suggestion for future research.

2 Theoretical and Empirical Literature Review Framework

Three categories of both theoretical and empirical literature review with regard to the directional causality relationship between exports and foreign direct investment have been discussed in this section. The first category states that FDI positively influence exports (FDI-led exports hypothesis) whilst the second category (exports-led FDI hypothesis) says exports growth spur FDI. The third category stipulates that both FDI and exports influence each other (feedback hypothesis).

Studies that are consistent with the first category include but not limited to Kosekahyaoglu (2006), Dasgupta (2009), Lee et al (2007), Tekin (2012), Xing (2007), Alguacil and Orts (2002), Xuan and Xing (2008), Andraz and Rodrigues (2010), Adhikary (2012), Akoto (2012), Zhang and Song (2000). In a study on Poland, Kosekahyaoglu (2006) revealed findings that are consistent with other FDI-led exports hypothesis. Using time series data analysis, Dasgupta (2009) established that FDI outflows negatively Granger caused by exports growth in India without any feedback. The performance of the exports sector heavily relied on the quantity of outbound FDI for India, argued Dasgupta (2009). Moreover, Lee et al (2007) suggested that the causality relationship between exports and FDI depends on the type of the industry. FDI was found to have Granger caused exports in labour intensive industry whilst exports positively influenced FDI in capital intensive industries in both Korea and China, revealed Lee et al (2007).

Using panel data analysis, Tekin (2012) discovered a uni-directional causality relationship running from FDI to real exports in Yemen, Niger, Chad, Benin, Haiti, Mauritania and Togo. Moreover, Xing (2007) found out that Japanese direct investment played a significant positive role in positively influencing bilateral intra-industry trade between Japan and the US. However, the same study by Xing (2007) found no evidence that US direct investment promoted the growth of intra-industry between Japan and the US.

Using the vector autoregressive model and controlling for relative market size and prices, Alguacil and Orts (2002) found evidence of a uni-directional causality relationship running from foreign direct investment to exports without any feedback effects in Spain. In an empirical study, Xuan and Xing (2008) found out that FDI from 23 countries was one of the major factors that positively influenced exports growth in Vietnam. A 1 percent increase in FDI inflows gave rise to a 0.13 percent increase in Vietnam's exports to the FDI source countries, revealed Xuan and Xing (2008). Employing the three-stage procedure based on unit root test, co-integration and Granger causality tests, Andraz and Rodrigues (2010) discovered results that are consistent with other FDI-led exports hypothesis proponents both in the short and long run in Portugal.

Adhikary (2012) suggested that Bangladesh should formulate FDI friendly policies in order to stimulate exports growth. This suggestion by Adhikary (2012) was on the backdrop of research findings that concurred with the FDI-led exports growth hypothesis both in the short and long run in a study on Bangladesh. Akoto (2012) agreed with Adhikary (2012) and other empirical studies whose findings confirmed FDI-led exports hypothesis in the long run. Export volumes went up by 1.87 percent in response to a 10 percent increase in FDI inflows in South Africa, according to Akoto (2012). According to a study carried out by Zhang and Song (2000), FDI positively Granger caused provincial manufacturing exports growth in China. A 0.29 percent increase in exports in the following year was found to be as a result of a 1 percent increase in FDI inflows in the previous year, revealed Zhang and Song (2000).

The second category which stipulates that exports promote FDI was undertaken by Tekin (2012), , Zhang and Felmingham (2001), Djokoto (2012), Dash and Sharma (2011), among others. Using panel data approach, Tekin (2012) found out that real exports Granger caused FDI in countries like Madagascar, Malawi, Senegal, Zambia, Rwanda, Mauritania and Haiti. Zhang and Felmingham (2001), using panel analysis established that exports Granger caused FDI in medium FDI recipients regions of China. Moreover, Falk and Hake (2008) using panel data approach that included seven European Union countries revealed that exports positively influenced FDI without any feedback effects. The same study when it used destination country in the panel data analysis produced similar findings.

Djokoto (2012) also discovered results that are consistent with the exports-led FDI hypothesis in Ghana. Agricultural exports were found to have Granger caused FDI inflows without any feedback effect in the long run in Ghana, according to Djokoto (2012). Using Vector Autoregression (VAR) model, Dash and Sharma (2011) discovered a uni-directional Granger causality relationship running from exports to FDI without any feedback whilst imports and FDI were found to have promoted each other in India.

The third category (feedback view) which mentions that both FDI and exports promote each other were done by Kosekahyaoglu (2006), Klasra (2011), Aizenman and Noy (2006), Zhang and Felmingham (2001), Wong and Tang (2007), Akoto (2012), Liu et al (2002), Pfaffermayr (1994), among others.

A study by Kosekahyaoglu (2006) suggested the existence of feedback effects between FDI and foreign trade in Czech Republic and Hungary. Using the recently developed autoregressive distributed lag

(ARDL), Klasra (2011) discovered the existence of a bi-directional relationship between exports and FDI in Turkey. According to Klasra (2011), both FDI and exports complimented each other in Turkey. Aizenman and Noy (2006) also revealed the existence of a bi-directional Granger causality relationship between FDI and exports in developing countries. They discovered a Granger causality from FDI to trade openness to be represented by an elasticity of 50% and FDI to have been 31% Granger caused by exports in developing countries. Employing error correction modeling (ECM) technique, the national research during the period 1986 to 1999 carried out by Zhang and Felmingham (2001) revealed the existence of a bi-directional causality relationship between exports and FDI in China. However, the same study produced the same results when a different methodology (panel data approach) was used. Using panel data analysis, Zhang and Felmingham (2001) revealed the existence of feedback effects in both high FDI recipients (HFDI) and low FDI recipients (LFDI) regions of China.

According to Wong and Tang (2007), FDI and Malaysia's top five electronics exports promoted each other or had a bi-directional causality relationship in the short run whilst in the long run FDI was found to have been Granger caused by electronics' exports in Malaysia. On the other hand, Akoto (2012) established the existence of a bi-directional causality relationship between FDI and exports in the short run in South Africa. Moreover, Ahmadi and Ghanbarzadeh (2011) revealed in a panel data analysis study that FDI and exports promoted each other in the Middle East and North Africa (MENA) region. Liu et al (2002) discovered that in the long run, exports, imports and FDI were co-integrated in China. The causality was specifically found out to be bi-directional between exports and FDI in the long in the Republic of China. Using multivariate time series approach, Pfaffermayr (1994) found out a bi-directional causality relationship between FDI and exports in Austria. Exogenously foreign direct investment was found to have a strong positive impact on exports whilst export shocks were discovered to have a negative influence on foreign direct investment in Austria revealed Pfaffermayr (1994).

3 Case Study - Botswana

The trend for FDI inflows has been mixed whilst that of exports of goods and services exhibited a general increase for Botswana during the period 1980 to 2011 (see Figure 1). FDI net inflows went down by 51.94%, from US$111.55 million in 1980 down to US$53.61 million in 1985 whilst exports of goods and services increased by 31.28% during the same period. FDI net inflows and exports increased by 78.86% and 182.4% respectively during the five year period ranging from 1985 to 1990. The period 1990 to 2000 saw FDI inflows experiencing consistent decline whilst exports continued on the upward trend. Exports of goods and services increased by 16.52%, from US$2 086.92 million to US$2 431.81 million whilst on the other hand FDI inflows registered a decline of 26.57% during the same period. Whilst FDI inflows further took a plunge by 18.8% during the period 1995 to 2000, exports of goods and services continued on an upward trend by registering a 23.37% growth to reach US$3 000.19 in 2000.

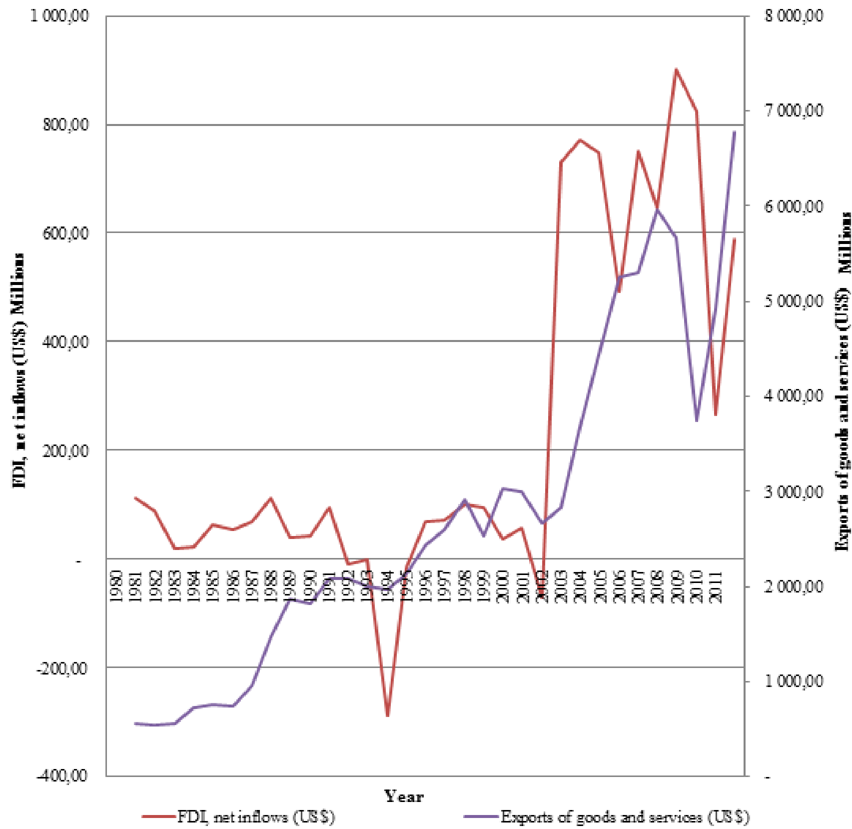
Both FDI inflows and exports of goods and services registered an increase of 761.17% (from US$57.18 million to US$492.38 million) and 75% (from US$3 000.19 million to US$5 255.96 million) respectively during the period 2000 to 2005. On the contrary, both exports of goods and services and FDI inflows plummeted by 6.46% and 46.19% respectively during the period between 2005 and 2010. FDI inflows declined from US$492.38 million in 2005 down to US$264.95 million in 2010. The year 2011 saw both FDI inflows and exports of goods and services registering positive growth rates. FDI inflows went up by 121.59%, from US$264.95 million in 2010 to US$587.12 million in 2011 whilst exports of goods and services also increased by 37.95% (from US$4916.67 million to US$6782.32 million) during the same period (see Figure 1).

Figure 2 shows FDI, net inflows (% of GDP) and exports of goods and services trends for Botswana during the period 1977 to 2011.

FDI, net inflows (% of GDP) experienced a consistent decline during the period 1980 to 2000 whilst the trend for exports of goods and services (% of GDP) has been mixed for Botswana. The former declined by 5.71 percentage points, from 10.51% in 1980 down to 4.81% in 1985 whilst the latter went up by 13.23 percentage points during the same time frame. Both FDI, net inflows (% of GDP) and total exports (% of GDP) plummeted by 2.28 percentage points and 11.24 percentage points respectively during the period 1985 to 1990. The negative trend persisted between 1990 to 1995 for both variables. FDI, net inflows (% of GDP) further declined by 0.46 percentage points, from 1.48% in 1995 down to 1.02% in 2000 whilst the same period saw exports of goods and services (% of GDP) increased by 2.32 percentage points.

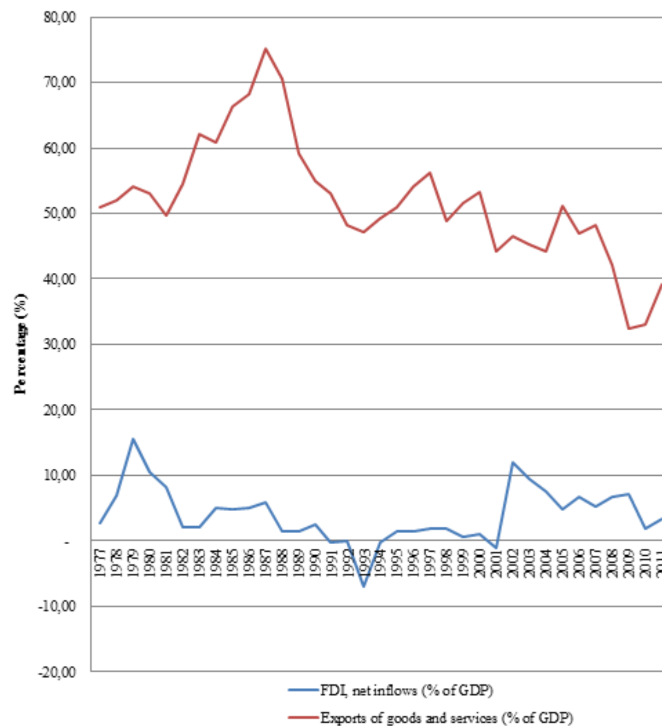
However, exports of goods and services (% of GDP) declined by 2.01 percentage points during the period 2000 to 2005 whilst FDI, net inflows (% of GDP) surged by 3.79 percentage points during the same time frame. The time frame 2005 to 2010 saw both FDI, net inflows (% of GDP) and exports of goods and services (% of GDP) plummeting by 3.02 percentage points and 18.26 percentage points respectively. However, the year 2011 saw both variables going up. FDI, net inflows (% of GDP) went up by 1.61 percentage points, from 1.78% in 2010 to 3.39% in 2011 whilst exports of goods and services (% of GDP) also increased by 6.15 percentage points (from 32.99% to 39.14%) during the same time frame.

Figure 1. Foreign Direct Investment, net inflows (US$) and Exports of Goods and Services (US$) Trends for Botswana -1980 to 2011



Source: World Bank (2011)

Figure 2. FDI, net inflows (% of GDP) and Exports of Goods and Services (% of GDP) Trends for Botswana -1977-2011



Source: World Bank (2011)

4 Conclusion and Suggestion for Future Research

This research investigated the existence and causality relationship between exports and FDI from a theoretical and empirical literature conceptual framework point of view. The literature extensively discussed the three prominent views explaining the causality relationship between the two variables. FDI-led exports hypothesis is the first view which mentions that exports can increase or decrease in direct response to changes in foreign direct investment inflows or outflows. The second view which is exactly the opposite of the first view is known as the Exports-led FDI hypothesis. The third view (feedback hypothesis) says that there is a direct bi-directional causality relationship between exports and foreign direct investment. The literature review conceptual framework analysis revealed the FDI-led exports hypothesis to have been more popular among previous researchers. The study therefore recommends the creation of the conducive environment that attracts FDI inflows by the host country in order to spur export sector and economic growth. For future study, the author is firmly of the opinion that other factors that indirectly influence FDI and exports relationship needs to be investigated in order to gain a deeper understanding of how these two variables relate to growth.

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CORPORATE GOVERNANCE COMMUNICATION AND VALUE CREATION

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Abstract

Corporate scandals and the ongoing economic crisis have heightened academic and practitioner interest into corporate governance. Resulting corporate governance codes and related legislative developments place increasing emphasis on what companies should communicate on their governance arrangements. But whether and how corporate governance communications add value to companies remains a subject of debate. To shed light on these questions, we review two hitherto unconnected and parallel literatures from accounting and finance, and corporate communications research respectively. We develop a multi-dimensional model of corporate governance communications to explain the contingent conditions that can lead to value creation.

Keywords: Value Creation; Corporate Governance; Corporate Scandals

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1 Introduction

In the wake of the corporate scandals of the 1990s and 2000s, corporate governance systems, structures and processes have been the subject of much academic research and practitioner interest (Daily *et al.* 2003; Huse, 2005, Shleifer & Vishny, 1997). In an attempt to improve 'good governance', corporate governance codes have been introduced worldwide (Aguilera and Cuervo-Cazzura, 2004). Regardless of their national specificities, the underpinning philosophy is that corporate transparency and associated corporate disclosures are key components of 'good governance' (OECD, 2004). Subsequently, we have witnessed ever increasing volumes of corporate communications, from mandated disclosures on financial reporting and compliance with corporate governance codes, to voluntary disclosures on strategy developments or Corporate Social Responsibility (CSR).

These developments raise several issues for scholars. First, the underlying assumption that more communication on corporate governance always produces better outcomes for firms and shareholder is questionable (Hermalin and Weisbach, 2012). Agency theory scholars have argued that through reduced information asymmetries, corporate governance communications can lower costs of capital and produce more accurate analyst forecasts (Healy and Palepu, 2001). These advantages are tempered, however, by the costs such communications generate (Craven and Marston, 1999), the adverse effects of disclosing commercially sensitive information (Hayes and Lundholm, 2006), and the possibility of additional agency costs such as increased executive compensation (Hermalin and Weisbach, 2012). The second question that arises is *how* such corporate disclosures are best attained. The literature shows that there is a wide diversity of content and presentation not only in annual reports (Beattie *et al.* 2008; Frownfelter-Lohrke and Fulkerson, 2001; Thomas, 1997), but also in other media such as the internet (Bollen *et al.*, 2006; Craven and Marston, 1999). Moreover, recent developments in social media platforms are changing at a fundamental level how companies communicate with their stakeholders (Crawford, 2009).

Answering these questions also has implications for practice. In an age characterised by vast and almost instantaneous information flows, the failure to deliver the right information at the right time can negatively affect investor relations (Deller *et al.*, 1999) and damage reputation (Argenti and Haley, 2006). Hence, company websites and preliminary announcements are assuming an ever greater importance as vehicles for corporate communications. In addition to the choice of media, there is the question of how content is best structured, narrated and displayed.

Ultimately, the underlying question is whether, and if yes how, corporate communications on governance add value to the organisation, its shareholders and/or other stakeholders. To this end,

we review and synthesise the extant literature on communicating corporate governance and value creation. By bringing together two hitherto unconnected literature streams, from finance/accounting and corporate communications respectively, we aim to provide new insights into corporate governance communications. Following a brief summary of concepts used to describe the outcomes of corporate governance, we outline the theoretical basis for linking corporate communications and value creation, and discuss the extent to which there is supporting empirical evidence. We finish by distilling a number of 'best practice' recommendations for communicating corporate governance.

2 Corporate Governance and value creation

In order to understand whether and how communicating corporate governance contributes to value creation, it is perhaps important to first consider the scope of the concept of corporate governance, and associated with these conceptual issues the outcomes of corporate governance.

Agency theory continues to be the dominant theoretical perspective in corporate governance research (Daily et al., 2003; Gabrielsson and Huse, 2004), and one which underpins many definitions such as those by Shleifer and Vishny (1997) or Denis and McConnell (2003). In agency theory, the interests of managers and shareholders are essentially divergent and corporate governance is defined in terms of the mechanisms that ensure managers act in the best interest of the corporations' principals (shareholders) and maximise shareholder value (see also section 3.1. below). Other definitions, such as those by Huse (2007) and the OECD (2004), adopt a broader perspective by defining corporate governance in terms of directing companies towards value creation, which in turn involves interactions, systems and processes between a wider group of firms' actors and/or stakeholders. Despite the differences in narrow shareholder versus broader stakeholder conceptualisations of corporate governance, these definitions share common ground insofar as they view some sort of value creation to be an outcome of corporate governance. How such value creation is defined, who benefits from it, and how we can measure the outcomes, are questions which are addressed below.

Table 1. Corporate governance outcomes: definitions and measurements

Concepts used to describe governance outcomes	Beneficiary	Measurements
Shareholder value (Epstein and Roy, 2004; Pitman, 2003; Zahra and Pearce, 1989)	Shareholders	Stock price, return on investment, dividend growth, total return to investors, Sustained value growth
Firm value (Huse, 2007)	Firm and its stakeholders (including, but not exclusive to, shareholders)	Porterian value chain analysis (resource acquisition, operation, innovation, resource allocation, implementation, distribution)
Firm performance:		
Financial/economic performance (Bushman and Smith, 2003; Zahra and Pearce, 1989)	Financial investors	Return on assets, return on equity, return on sales, dividend per share, net profit margin
Non-financial performance (Hillman, Keim, and Luce, 2001)	Employees, customers, environment, community	Employee well-being, workplace safety, customer satisfaction, product development, environmental performance, community relations

As is shown in table 1, the literature uses slightly different concepts to describe and measure the outcomes of corporate governance. Most commonly, these outcomes of governance are seen in economic/financial benefits accruing to shareholders of corporations (typically described in terms of performance and/or shareholder value), with financial accounting metrics used to quantify these benefits. However, the emphasis on financial economic returns to shareholders has increasingly been critiqued. First, accounting metrics are in the main backward-looking, or lagging, performance measures. Thus, they can be a poor basis on which to predict future performance and/or devise incentive systems for management (Aerts *et al.*, 2007; Epstein and Roy, 2004). Second, several accounting measures have been critiqued for being open to manipulation and distortion, and for lacking standardisation in international accounting

(Huse, 2007). Thus, companies such as Enron or Parmalat were able to mask poor performance over a period of time (Benston, 2006). Third, these outcomes and measures are based on the acceptance of the primacy of shareholders over other stakeholders, a view that has increasingly been challenged as being harmful to corporations and investors (Stout, 2012), or at least inadequately capturing the corporate objectives (Freeman, et al., 2004). Fourth, the focus is of these financial/economic outcomes is on tangible, and often easy to capture and quantify, measures. Increasingly, the literature points to the need to evaluate more intangible outcomes and associated qualitative variables such as reputation, corporate image or corporate identity as proxies for performance (Argenti and Druckenmiller, 2004; Cravens *et al.*, 2003; Dolphin, 2004; Forman and Argenti, 2005; Kim *et al*., 2007; Melewar, 2003). In summary, a narrow focus on economic/ financial returns has various shortcomings as it captures value creation incompletely and sometimes misleadingly.

Huse (2007) has argued for a using a more comprehensive framework for defining and measuring value creation. In the framework, he distinguishes between internal value creation, i.e. strategies, processes and policies that enhance the value chain internal to the organisation, and external value creation, i.e. firm-specific outcomes that are of value to external stakeholders. Huse (2007) further separates value creation that can purely be understood and measured in economic terms, and value creation that has a social dimension. The resulting categories, however, are not mutually exclusive. For example, there is a wealth of evidence that links internal value creation processes to financial performance (Zahra *et al*., 2000), or social value creation with economic performance (Orlitzky and Benjamin, 2001; Orlitzky *et al.*, 2003). As Porter noted already in 1985, companies which are sustainably successful pay attention to value creation along the entire business value chain, not only the final value dispersion to shareholders (Huse, 2007; Porter, 1985). Thus, value creation should not be viewed solely as a short-term economic risk/return calculation, but a broader spectrum of internal and external processes, strategies and behaviours (including tangibles and intangibles) that sustainably promote successful business growth in the long term.

That leaves the questions of how shareholders and other stakeholders learn about organisations' value and corporate governance, and this is where corporate communications plays a pivotal role. The literature uses a number of terms for describing the means and processes by which companies communicate with their stakeholders, and these are summarised in table 2.

Most commonly, the literature uses the terms 'disclosure', and to some extent also 'financial reporting' to describe the mechanisms by which companies communicate with outside parties. Such disclosures are divided into mandatory ones stipulated by law, which in the main relate to the production, publication and dissemination of company accounts and corporate governance arrangements, and voluntary ones. The latter have mainly been described as the range of non-financial information disclosures that companies make in order to provide investors with lead indicators on future performance (Aerts *et al.*, 2007) and/or to supplement mandatory accounting disclosures in order to contextualise and explain such accounting data to investors (Healy and Palepu, 1993).

The terms 'disclosure' and 'financial reporting' are found primarily in the economics, finance and accounting literature, and implicitly or explicitly denote a one-way communication from companies to current or potential investors. Scholars with a background in communication studies tend to use terms such as 'corporate communications', 'investor relations' and/or transparency' (Argenti, 2006a; Parum, 2006). Whilst these concepts still include the notion of information dissemination to investors, they have a broader meaning than 'disclosures' as they typically encapsulate how and why companies communicate with external actors (Argenti, 2006b). Thus, the study of corporate communications also pays attention to issues such as channels of communication (print versus online), communication quality (credibility, timeliness, presentation, accuracy etc.), communication context (development of media, market for corporate communications), and communication processes (directionality, scope for dialogue with investors) as indicators of how effective communications are (Parum, 2005). Additionally, corporate communications are affected by prevalent corporate values and fit (to varying degrees) into the broader strategic context of the organisation (Argenti, 2006b). Therefore, corporate culture and the specific strategic context are important variables that explain how and why companies communicate.

Disclosures, or the mechanisms for providing information to investors, are thus best viewed as a sub-set or element of corporate communications. Why companies engage in corporate communications, and how communicating corporate governance may affect firm value, are questions that we seek to address in the following section.

Table 2. Summary of terms used to describe communications between companies and stakeholders

Term/concept used	Author(s)	Description/ notes
Corporate Disclosure (financial/non-financial; compulsory/voluntary)	Aerts *et al.* (2007); Aksu and Kosedag (2006); Beattie *et al.* (2008); Collett and Dedman (2010); Craven and Marston (1999); Forker (1992); Gibbins *et al.* (1990); Healy and Palepu (1993, 2001)	Mechanisms for managers' communication with outside stakeholders; includes mandatory accounting disclosures and voluntary non-financial disclosures (e.g. CSR disclosures, information on business strategy, product development, client profiles)
Financial Reporting	Melis (2004)	"The term financial reporting incorporates not only financial statements, but also includes other means of communicating financial and non-financial information, e.g. management forecasts, stock exchange documents etc." (Melis, 2004: 32)
Corporate communications	Argenti (2006a, 2006b); Forman and Argenti (2005); Parum (2006); Subramanian *et al.* (1993)	Corporate communications can be seen as: a/ an organisational function (like marketing) b/ a channel of communications (print or electronic) c/ a communication process (style of communication) d/ an attitude or set of beliefs (inherent values communicated) (Argenti 2006b) Overall, seen as a structured dialogue (Parum, 2005) between companies and their shareholders and other stakeholders; includes both external communications (company reports, external websites, press releases and external ratings) and internal communications (intranets, employee communications)
Investor relations	Bollen *et al.* (2006); Deller *et al.* (1999)	"…the strategy of corporations with regard to communication targeting current and potential investors." (Deller *et al*, 1999:352): included corporate reports, company website, interim reports, AGM, press conferences, round tables, 1:1 discussions and phone calls
Transparency	Bushman and Smith (2003)	Includes types of disclosures (financial accounting, governance); quality of disclosure (timeliness, credibility, availability in English); information dissemination (degree to which information is spread via media); and private information acquisition and reporting (analyst following, information communications, institutional investors)

3 Communication of corporate governance and value creation: theoretical underpinning and empirical evidence

There are two broad strands of literature that investigate the link between corporate governance communications and value creation. One strand has its origins in economics, accounting and finance and focuses primarily on the effects of corporate disclosures on capital markets (Leuz and Verrecchia, 2000). The second area is in the comparatively more recent field of corporate communications and seeks to establish the factors that influence effective corporate communications, and the extent to which such communications, via effects on reputation and company image, contribute to corporate objectives. The following sections present a review and summary of these different approaches to theorising about, and measuring, corporate communications and value creation.

3.1 Economic-financial perspectives on corporate governance communications

Within the economics and finance literature, there are three theoretical strands which seek to explain why corporations make disclosures to investors and other stakeholders, and what the effects of such disclosures are on capital markets and the economic performance

of the corporation. The first strand, a*gency theory*, dates back to the seminal work by Berle and Means (1933) and was later developed by Jensen and Meckling (1976). Based on the premise that in modern corporations ownership and management are separated, and that individuals seek to maximise their own utility, the interests of internal managers and outside shareholders diverge. In other words, managers may seek to pursue their own objectives such as maximising their earnings which could be to the detriment of shareholders. Moreover, managers, by virtue of being involved in the day-to-day running of the company, have superior information about the company's performance compared to outside investors. These information asymmetries, in combination with the assumed self-seeking interests of managers, mean that shareholders incur costs by having to monitor and control managers. Corporate governance, in the tradition of agency theory, is about mechanisms such as boards of directors, or the market for corporate control, which serve to align the interests of internal managers with those of the shareholders (Eisenhardt, 1989).

In the context of agency theory, corporate disclosure and communications are a key instrument for remedying one of the underlying problems to agency relations: information asymmetries. By providing existing and potential investors with financial and non-financial information about current firm performance, and forecasts on future performance trends, two effects are achieved. First, high quality information allows investors to more accurately value companies and this in turn improves the functioning of capital markets. If there is little or no detailed and reliable information about companies, a 'market for lemons' (Akerlof 1970) exists whereby good companies or projects may be under-valued and poorly performing companies or risky projects over-valued. In the absence of information on performance, capital markets would tend to converge to an average, i.e. value both good and poor performers at an average, meaning that good performers pay a higher premium for raising capital, and conversely poor performers a lower premium. Thus, one effect of detailed and accurate disclosure is a better functioning capital market which in turn will lower the costs of raising capital for companies, will lead to increased liquidity in markets (as there is less risk for investors of adversely selecting a poor investment project), and lead to more accurate analysts' forecasts (Aksu and Kosedag, 2006; Bushman and Smith, 2001; Craven and Marston, 1999; Healy *et al.*, 1999; Healy and Palepu, 1993, 2001).

The second effect of high levels of quality disclosure relates to the agency problem once the investment has taken place (e.g. shares have been bought). Assuming that managers are motivated by self-interest, there is a danger that managers may not use these funds to maximise returns to shareholders or misuse funds for personal gain. Disclosures may help shareholders and boards to better monitor and control the actions of management, thus reducing the likelihood that managers expropriate wealth (Bushman and Smith, 2001, 2003; Healy and Palepu, 2001). But there may also be a downside to information disclosure within an agency-theoretic framework. Hermalin and Weisbach (2012) theoretically demonstrate that disclosures improve principals' decision-making, but at a certain point of disclosure additional agency costs can occur in the form of higher executive compensation. Overall, the argument from agency theory scholars is that the narrowing of information asymmetries between shareholders and managers is the basis on which investors are able to better protect their investment from potential managerial abuse.

Whilst agency theory focuses primarily on the effects of improved information on investment decisions and capital markets, a second related theoretical strand investigates the way in which companies strategically use disclosures to enhance firm value. *Signalling theory* argues that companies use corporate communications to send signals to investors about their profile and high quality (Craven and Marston, 1999). For example, by using well developed websites, companies communicate their competencies in using information technology to investors. Or by disclosing information on the board of directors, companies may seek to signal the quality, reputation and integrity of their upper echelons (Bushman and Smith, 2003). The signals are therefore more about communicating intangible qualities or values, and investors and analysts receiving these signals may in turn value companies more highly. Thus, good communications and firm performance are seen as creating a positive feedback loop.

These two theoretical approaches, *agency* and *signalling theory*, by and large assume that greater and better disclosures are ultimately beneficial to firm value. The third strand in the economics and finance literature is a multi-theoretic one and is based on a *cost/benefit approach*. Scholars from this tradition argue that companies calculate and weigh up the costs and benefits of making disclosures, especially voluntary, non-financial disclosures (Aerts *et al.*, 2007; Craven and Marston, 1999; Deller *et al.*, 1999). Benefits of disclosures in terms of shareholder investment decisions and risk assessment are derived from agency theory, whereas signalling theory points towards the benefits in terms of intangibles such as reputation or image. Yet there also costs. Information needs to be collected, collated, processed and professionally presented. Theoretically, large firms are more likely to be able to absorb these costs than smaller firms (Hermalin and Weisbach, 2012). Furthermore, if information is made publicly available in annual reports or websites, it is not only investors or analysts who are able to access that information but also competitors, which may result in a trade-off between capital market benefits and the costs of

aiding competitors (Hayes and Lundholm, 1996). The resource-based view of the firm suggests that the more intangible resources a firm possesses, and the more difficult these are to replicate, the more competitive the firm is likely to be in the long run (Barney, 1991, 2001; Barney, *et al.* 2001). If companies disclose details on, for example, their product development, strategic posture or organisational culture, it could place them at a competitive disadvantage if rivals are able to use that information. Companies therefore have to find the right balance between satisfying information needs of investors and analysts, and protecting commercially sensitive information from rivals.

Empirical research on the link between corporate communications and firm value tends to show some support for the positive effects of better disclosures, albeit under some important country- and firm-level contingencies. Specifically, the literature reveals that:

- ✓ Increasing levels of disclosure have benefits in terms of investor's share valuations, stock liquidity, cost of capital and share performance (Healy *et al.*, 1999; Healy and Palepu, 2001; Leuz and Verrecchia, 2000).
- ✓ Levels of disclosure are related to analysts' following and the range and accuracy of analysts' forecasts (Aerts *et al.*, 2007; Healy *et al.*, 1999; Healy and Palepu, 2001).
- ✓ Companies in countries with well-developed capital markets (US, UK) show greater levels of communication, both paper and web-based (Aerts *et al.,* 2007; Bollen *et al.*, 2006; Deller *et al.*, 1999).
- ✓ Larger companies have higher levels and higher quality communication than small ones (Bollen *et al.*, 2006; Craven and Marston, 1999).
- ✓ There is little research and non-conclusive evidence of signalling effects (Bollen *et al.*, 2006; Dolphin, 2004).

The above findings, however, have a number of limitations. First, the majority of studies are located in the U.S. context which is characterised by highly developed capital markets and an information-rich environment (Deller *et al.*, 1999; Leuz and Verrecchia, 2000). Second, there are methodological challenges in disentangling the cause-effect relationship between disclosures and market outcomes, and whether corporate governance acts as an antecedent or consequence to that relationship (Collett and Dedman, 2010). Finally, these studies tend to tell us about market consequences of disclosures but relatively little about broader aspects of corporate communication. In order to better understand dimensions of communications that may influence their impact, in the following part we will turn our attention to the communications literature.

3.2 Corporate Communications

Compared to the economics/finance literature, corporate communications literature is a more recent domain. Broadly speaking, scholars here have sought to understand how and under what conditions communications evolve, and what makes communications effective. As such, the literature has a much stronger focus on the less tangible aspects and effects of communications, but fits better into the broader conceptualisation of value creation as outlined by Huse (2007) discussed above.

Corporate communications is a very fast-moving area and has seen many changes which affect the way in which companies communicate with shareholders and other stakeholders (Kaplan and Haenlein, 2010). Several scholars have argued that the changes brought about by the digital age create challenges as well as opportunities for corporate communications, these are summarised in table 3.

Table 3. Changes, challenges and opportunities in corporate communications

Changes and challenges	Opportunities
• Less control by companies over information and communication	• Greater ability to use technology to measure impact of communications
• All stakeholders have easier and cheaper access to information	• Greater scope for visualisation and inter-activity
• Communications are more dynamic and less static (less opportunity for 'prepare and tell')	• Value of listening to stakeholder groups
• Possibility that corporate vision and values get challenged by stakeholder groups (employees, environmental groups) leading to damage of corporate image	• Increased effectiveness of communications through higher degree of integration
• Maintaining coherence across multiple media channels	• Ability to communicate quicker and to more diverse audiences

Source: Argenti (2006b), Crawford (2009), Kaplan and Haenlein (2010)

Given these challenges and opportunities, the issue arises as to what factors affect the effectiveness of corporate communications. Scholars have used different concepts to describe and measure the effectiveness of communications. The most widely used concepts in the literature include *reputation*

(Argenti and Druckenmiller, 2004; Cravens *et al.*, 2003; Dolphin, 2004; Forman and Argenti, 2005; Kim *et al.*, 2007; Melewar, 2003), *credibility* (Jones, 2002), *brand value* (Argenti and Druckenmiller, 2004; Forman and Argenti, 2005) and *corporate identity* (Argenti and Druckenmiller, 2004; Melewar, 2003; Parum, 2006). What we have seen in the literature and in practice is an increasing move away from counting outputs of communications (such as press or analysts reports) towards measuring the value created by corporate communications.

Despite the differences in how the literature describes and measures the value created by communications, there is broad agreement on the influences, or factors affecting this value creation. In a survey of corporate governance communications via websites of international companies, Jones (2002) and Deller *et al.* (1999) found that there were five variables influencing the effectiveness of communications:

1. *Completeness of information* (as information is easily accessible by stakeholders, any omissions or errors are easily identified)
2. *Verifiability of communications* (more believable if there are objective measurements, substantiation of statement and/or independent verification)
3. *Familiarity* (investors perceive communications to be of better quality of they are in a format that they are familiar with)
4. *Responsiveness* (measure of how serious companies are about communicating with investors and other stakeholders, i.e. are contact details easy to locate, chat settings)
5. *Ease of use* (the experience of finding and navigating the website can influence how company is perceived, i.e. difficult to navigate websites can create impression that company does not want to communicate or is hiding things)

Whilst the above findings relate to an analysis of electronic communications, which themselves account for an increasing volume of corporate communications and analysts' traffic, similar dimensions have also been identified in print media (Beattie *et al.,* 2008; Subramanian *et al*., 1993). In a detailed longitudinal survey about changes in annual reports in the UK, Beattie *et al.* (2008) identified the following trends:

Table 4. Presentational changes in UK Annual Reports 1965-2004

Annual reports have increased from an average of 26 pages in 1965 to 75 pages in 2004. There has been a 186% increase in regulatory material presented, and a 190% increase in voluntary disclosures.
The amount of narrative information increased by 375%, pictorial information increased by 100%.
Financial statements are no longer included in the main body of Annual Reports but are presented in the appendices.
Design sophistication has increased sharply: 78% of companies in 2004 displayed prominent corporate logos at the front page (only 28% in 1965), and 72% used external design consultants (only 12% in 1965).
Graph usage has increased from 79% to 99%, but mainly showing benchmarked performance in non-key performance areas such as CSR. Graph usage for key financial variables has declined slightly.
There have been substantial changes in content with particular increases in corporate governance communications. In 2004, 98% of companies included a remuneration report, 89% provided information on their board, 85% included a dedicated corporate governance report, 65% presented shareholder information, 56% included a CEO statement, 51% had a dedicated Corporate Social Responsibility (CSR) section and 50% provided a statement of directors' responsibilities.
Material distortion of graphs has increased sharply, especially as a way of impression-managing poor performance
The use of visual images that are 'glamorous, kaleidoscopic and entertaining' (p.188) is increasing, strongly influenced by media representations such as television.

Source: derived from Beattie *et al*., 2008

What the findings summarised in table 4 suggest is that companies are increasingly professionalising annual reporting, and that information is no longer simply presented but increasingly contextualised and managed. To some extent, these changes are driven by regulatory pressures or corporate governance codes. For example, Beattie *et al.* (2008) assert that the increase in graph distortion may well be related to

the fact that as companies can no longer avoid reporting, they resort to presentational formats that put a positive gloss on areas of poor performance. This proposition is further supported by studies into the use of linguistic devices in annual reports. Subramanian *et al.* (1993) found a statistically significant difference in readability of annual reports between well and poor-performing companies. They furthermore noted that for poor performers the use of passive voice and sentence length increases substantially, and that there is a tendency to use de-emphasising techniques, for example, "favourable loss experience for the corporation" (Subramanian *et al.*, 1993, p.58. Thomas (1997) also found a correlation between the use of passive sentence structures and declining performance, and noted a tendency to use more factual language when performance worsened as a way of shifting responsibility from human agents (i.e. internal managers) to outside, non-human factors.

But are well-presented, interactive, easy-to-use and complete reports or websites sufficient in creating effective communications? A small number of articles suggest that unless there is a link between corporate communications and firm values and strategy, communications remain hollow, disconnected and ultimately have little impact on value creation. Forman and Argenti (2005) conducted a qualitative study into five large and internationally successful corporations (Accenture, Dell, FedEx, Johnson and Johnson, and Sears) and found that there were strong commonalities in the way which these companies deployed communications in order to create value via firm image and reputation:

1) Close alignment between the corporate communications function and implementation of strategy: regular involvement of communication professionals in strategy development and implementation, especially during times of strategic organisational change; corporate communications used to facilitate stakeholder buy-in into strategy

2) Direct reporting of corporate communications to CEO: communication executives had "seat at the CEO's table" (p.252) and where often directly line-managed by CEO; this conferred authority and legitimacy on communication function (see also Crawford, 2009)

3) Focus of communications on brand and reputation: recognition of the value of external ratings and the benefits of positive media attention for corporate reputation (see also (Argenti and Druckenmiller, 2004; Jones, 2002)

4) Alignment of internal with external communications: recognition of the importance of having integrated and consistent communications (see also Jones, 2002 and Argenti and Haley, 2006); buy-in from employees into strategy especially important in promoting consistent image

5) Use of IT to enhance communications: sends important signals to investors and stakeholders and can be important means of conveying and managing impressions of company (see also Craven and Marston, 1999 and Jones, 2002)

6) Corporate communications as art and science: important to use sophisticated performance measures to quantify results of communications but need to balance that with recognition that there are also intangible aspects such as the need to create the right impression (Forman and Argenti, 2005)

Although these conclusions are intuitively sensible, and backed up with qualitative data from the five case study companies, they do not provide substantive empirical evidence of the link, or the extent to which communications create firm value. In a methodologically more sophisticated paper, Kim *et al.* (2007) test for the link between different types of communications and profitability of firms. They developed two constructs by which companies could be categorised in terms of their communications. *Symbolic management* companies are those where corporate communications are strategically used to create a positive image among investors and the media. Those companies would prioritise resources in public relations and seek to manage impressions through positive signalling. *Behavioural management* companies, on the other hand, are those that align their corporate actions with the message from corporate communications. These behavioural management companies would seek to change their business actions and behaviours, and communicate that, rather than 'focusing on image-moulding rhetoric' (Kim *et al.*, 2007, p.78). The findings of their research suggest that symbolic management has only a weak correlation to profitability, whereas behavioural management creates a positive performance reputation which is strongly correlated to corporate profitability. In other words, using corporate communications as window-dressing may create short-term benefits for companies, but it is only when corporate actions and behaviours are consistently aligned with communications that there is a sustainable impact on firm value.

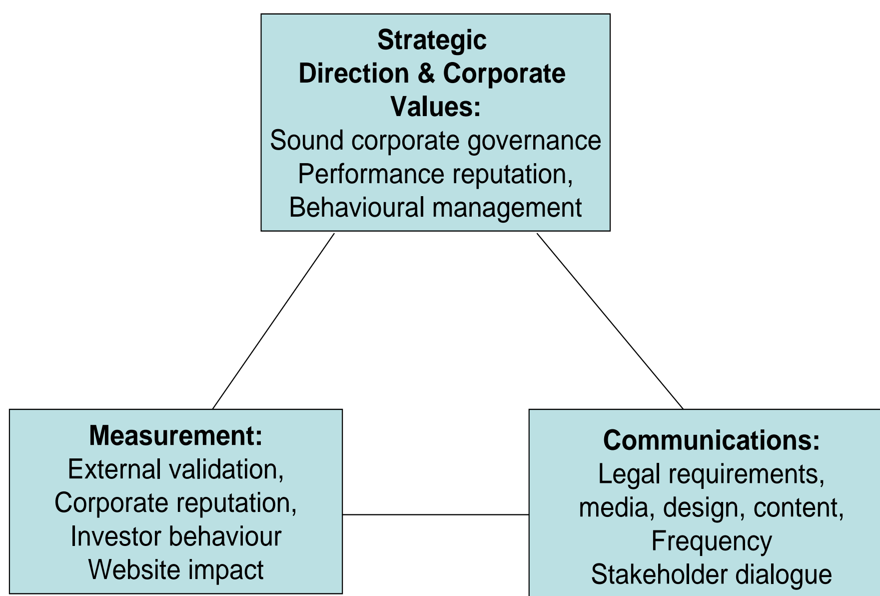
4 Best practice in corporate governance communications

Drawing together the literature streams discussed in section 3, we propose that corporate governance communications is not solely about what and how much is communicated, rather that there are multiple dimensions of 'best practice'. Research on corporate disclosures and communications makes reference to a concept called 'normalisation processes' (Beattie *et al.*, 2008). Essentially, a few high-profile companies tend to introduce innovations in their corporate communications, and this is followed by more widely-spread adoption until finally even laggards follow suit and the original innovation becomes the norm. Often a summary of 'best practice' is in fact happening at an advanced point of normalisation

when many companies have already adopted the practice and, more importantly, when there is evidence that it actually produces benefits for companies and their shareholders. Moreover, as resource-based theory tells us, if a practice or process is easy to imitate or copy by rivals, any competitive advantage deriving from it is only fleeting one and not sustainable in the long run (Barney, 2001). These caveats should be born in mind when developing and/or applying any best practice recommendations.

There are three inter-related dimensions that help us understand how corporate governance communications can create firm value, presented diagrammatically in Figure 1.

Figure 1. Dimensions of corporate governance communications



Communications need to be underpinned first and foremost by sound corporate strategies and organisational values (Forman and Argenti, 2005). Corporate governance, as previously noted, can be understood as a set of mechanisms and interactions that direct companies towards value creation and is thus intrinsically linked to organisations' strategic direction and values. Essentially, companies and their boards have to continuously focus on their value chain (Huse, 2007). Having clarity on one's overall strategy then links to the second dimension - the context and content of corporate communications. As previously discussed, companies need to meet minimum standards of communications required by law. This mandatory disclosure provides investors with a baseline upon which to base investment decisions (Eisenhardt, 1989; Healy *et al*., 1999). However, in order to allow for more accurate investment evaluations by market participants, and to support the creation of more intangible value elements such as corporate reputation, companies need make additional, voluntary disclosures and pay attention to what they communicate, how, with whom and how often (Aksu and Kosedag, 2006; Bushman and Smith, 2003; Healy *et al*., 1999; Healy and Palepu, 2001). In a summary of two reports by Deloitte, a professional management accounting publication (Anon, 1996) noted that most companies in the past under-exploited opportunities for communication because of three factors: 1) inadequate planning of their narrative or story they wanted to tell, 2) failure to deliver the right information at the right time and 3) inadequate assessment of performance against market expectations and benchmarks. The latter leads into the third best practice dimension – measurement. As Zairi (1994) notes "Quality improvement without measurement is like hunting ducks at midnight without a moon – lots of squawking and shooting with only random results and with a high probability of damage." (p.4). Again, there is no single formula or methodology for measuring the value creation of governance communications, however, there are a range of tools and techniques that companies can deploy:

1. External validation/benchmarks: There is strong evidence that measurements, indices or reports that are independently compiled and published have a strong impact on investor and consumer confidence (Aerts *et al*., 2007; Bronn, 2004; Jones, 2002; Pucheta-Martinez and de Fuentes, 2007). Furthermore, such independent ratings also provide a good yardstick for companies measuring their progress against competitors. Thus, pro-actively seeking out and participating in external surveys and indices creates real business advantages.

2. Exploiting technology: Technological advancements have created significant opportunities for measuring the impact of communications

(Argenti, 2006b). For example, technology is now available to assess the impact and use of websites, including blog tracking and analysis (Thelwall and Stuart, 2007).

3. Measuring intangibles: Academic researchers have for some time now developed models and metrics for measuring intangibles such as corporate identity (Melewar, 2003), investor behaviour (Healy and Palepu, 1993) or corporate reputation (Money and Hillenbrand, 2006; Rindova *et al.*, 2005). Making better use of this academic research can enable companies to measure the outcomes of corporate strategies and corporate communications in a more rigorous and informative fashion.

All three element described above – strategy and governance, communications and measurements – form a mutually re-enforcing loop. Although there is no magic recipe, evidence from the literature and practice suggests that internationally successful companies not only pay attention to all three elements but are also innovative and sophisticated in their application of these concepts.

5 Conclusion

In this article, we set out to investigate the link between communicating corporate governance and firm value. Scholars from different subject and methodological backgrounds have provided theoretical arguments and empirical evidence on why and how communicating corporate governance has an impact on firm value. That impact is on the hand via improvements in capital markets (i.e. share prices, cost of capital, liquidity) and on the other hand via improvements to more intangible outcomes such as corporate reputation and image. The literature furthermore provides clues about recent trends in communications and the factors that affect the effectiveness and credibility of communications. Based on these hitherto separate literature streams, we have synthesised dimensions of corporate governance communications based on firm strategy and values, communications and measurements. For companies that face increasing challenges arising from developments in digital and social media, these dimensions can inform a more holistic and integrated approach to corporate governance communications.

Our review also identifies a number of questions and gaps in our knowledge. To date, too little systematic attention has been paid to contingencies that affect the outcomes of corporate governance communications. At the macro-level, much of the empirical research has been carried out in the United States, and we need to have more evidence of capital market or reputation impacts elsewhere in the world (Leuz and Verrecchia, 2000). At the firm level, we need to better understand variances in the value-added of communications/disclosures for specific companies or sectors (Craven and Marston, 1999). Moreover, as communication media continuously advance and develop (Kaplan and Haenlein, 2010), we need to better understand how interactivity between different actors within and outside the organisation shapes the outcomes of corporate governance communications.

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THE OVERREACTION HYPOTHESIS: THE CASE OF UKRAINIAN STOCK MARKET

Ronald Henry Mynhardt*, Alexey Plastun**

Abstract

This paper examines the short-term price reactions after one-day abnormal price changes on the Ukrainian stock market. The original method of abnormal returns calculation is examined. We find significant evidence of overreactions using the daily data over the period 2008-2012. Our analysis confirms the hypothesis that after an abnormal price movement the size of contrarian price movement is usually higher then after normal (typical) daily fluctuation. Comparing Ukrainian data with the figures from US stock market it is concluded that the Ukrainian stock market is less efficient which gives rise to opportunities for extra profits obtained from trading based on contrarian strategies. Based on results of the research we also recommend some rules of trading on short-term market overreactions.

Keywords: Efficient Market Hypothesis; Overreaction Hypothesis; Abnormal Returns; Contrarian Strategy; Stock Market

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1 Introduction

The hypothesis that provided an analytical framework for understanding asset prices and their behavior is the efficient market hypothesis (EMH) (Fama, 1965and Beechey et al. 2000). According to Jensen (1978) there is no other proposition in economics which has more solid empirical evidence supporting it.

EMH points to the fact that all participants of financial markets are rational economic subjects and have equal access to information. As the result it is impossible to get additional profits, since all important information is already included in price (Fama, 1965). This means that it is impossible to identify undervalued assets and/or overvalued assets. Price of the asset does not depend on its price in the previous periods. That is why, according to EMH, the study of past price changes of the asset does not indicate the future direction of price movements.

However, a number of recent studies furnish evidence in favor of a certain level of predictability in price movements. As examples that can be mentioned are well known market anomalies: firm anomalies (size, closed-end mutual funds, neglect, institutional holdings etc), seasonal anomalies (January, weekend, time of day. end of month, seasonal, holidays etc.), accounting anomalies (Price/Earnings ratio, earnings surprises, dividend yield, earnings momentum etc.) and event anomalies (analysts' recommendations, insider trading. listings etc) (Levy, 2002).

Another important example of market inefficiency is market overreactions. Market overreactions were identified by De Bondt and Thaler (1985) who showed that investors overvalue the recent information and undervalue past information. The result of this is the following anomaly: Portfolios with the worst (best) dynamics during a three-year period prefer to show the best (worst) results over the next three years, the so-called overreaction hypothesis.

A special case of the overreaction hypothesis is short-term price reactions after one-day abnormal price changes. There is empirical evidence from different financial markets that after one-day abnormal price changes the size of contrarian price movement is higher than after normal (typical) daily fluctuations (Atkins and Dyl, 1990, Bremer and Sweeney, 1991, 1996, Cox and Peterson, 1994, and Choi, H.-S. and Jayaraman, N. 2009).

Despite a considerable amount of research already conducted on the overreaction theory, there are still a number of unsolved areas. For example, usually a single stock market is normally the only object of research. In our opinion it is important to research the overreaction hypothesis on different types of financial markets. In addition, the Ukrainian stock

market has never been the subject of overreaction hypothesis testing.

This paper aims to expand the overreaction knowledge by examining the existence of such anomaly in Ukrainian stock market and testing the overreaction hypothesis on different financial markets. The purpose of this study is therefore to confirm /reject the presence of abnormal counter-reactions after one-day abnormal price changes on different financial markets.

To confirm/reject the fact that the size of counter-reaction that occur after abnormal price fluctuations differs from the size of typical countermovement (countermovement after usual, standard day, without any overreactions) we use t-statistics. The excess of calculated t-test values over its critical value indicates that the presented data sets belong to different general populations. This, in turn, confirms the overreaction hypothesis.

We analyze data not only from Ukrainian stock market, but also from the US stock market (Dow Jones Index), FOREX (EURUSD) and commodity markets (gold, oil). This allows, on the basis of common methodology, to test overreaction theory on different types of markets. This approach also gives a possibility to compare results from different financial markets.

The remainder of this paper is organized as follows: A review of the existing literature on overreaction hypothesis and reasons for overreactions. A section that provides the methodology followed in the study. Next follows a section that presents the results and key findings of the study. Last there a section on the conclusions and summary of the paper.

2 Literature review

Despite some contradictory of EMH hypothesis (for example, asset prices have fundamental basis, existence of market anomalies), the law of random walk is confirmed both on practical and theoretical levels. To demonstrate this we have simulated the price dynamics (Figure 1) using the random generator of price changes with 50% chance. In Fig. 2, we present a fragment of graph, illustrated changes in prices of gold (day interval).

Figure 1. Graph of randomly generated values (probability 0.5)

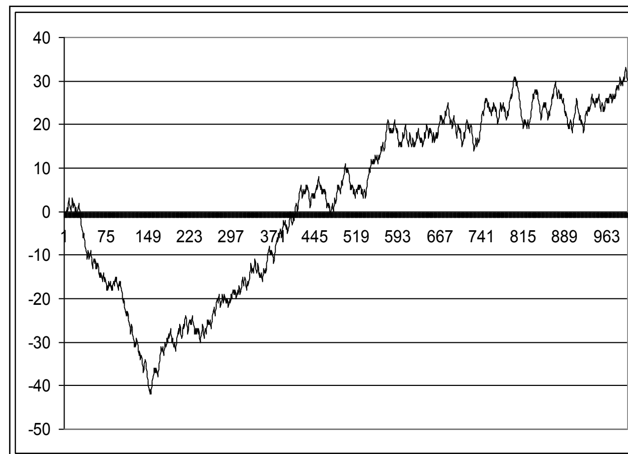


Figure 2. Fragment of gold prices chart (day interval)

Source: Archive of quotations MetaQuotes

Kothari and Warner (2006) conducted a study of scientific publications in favor of EMH. According to their results, there are more than 500 publications in top economic journals to testify in favor of the rational behavior of investors and their adequate and efficient response to new information. Nevertheless, empirical data from financial markets show that assumptions underlying the EMH do not always correspond to reality. The same applies to the main provisions of the efficient market hypothesis.

Discrepancies between the real life and EMH are observed in practice and in theory. Ball R. (2009) notes that the list of EMH inconsistencies is quite long and includes both market over- and under-reactions to certain information, volatility explosions and seasonal yield bursts, yield dependence on different variables such as market capitalization, dividend rate, and market factors.

2.1 Overreaction

Researchers pay much attention to the overreactions in the financial markets - significant deviations in price changes on assets from their average (typical) values during certain period of time. In Fig. 1 and 2 we showed graphs of randomly generated values and dynamics of real prices and concluded that they are quite similar. There are however situations in the market which cannot be simulated by random generation. For example, random generation will fail to display the picture, which took place in 2008-2010 in the U.S. stock market (Fig. 3). This is a typical case of overreaction.

Figure 3. Dynamics of Dow Jones Industrial Average Index during 2000-2013

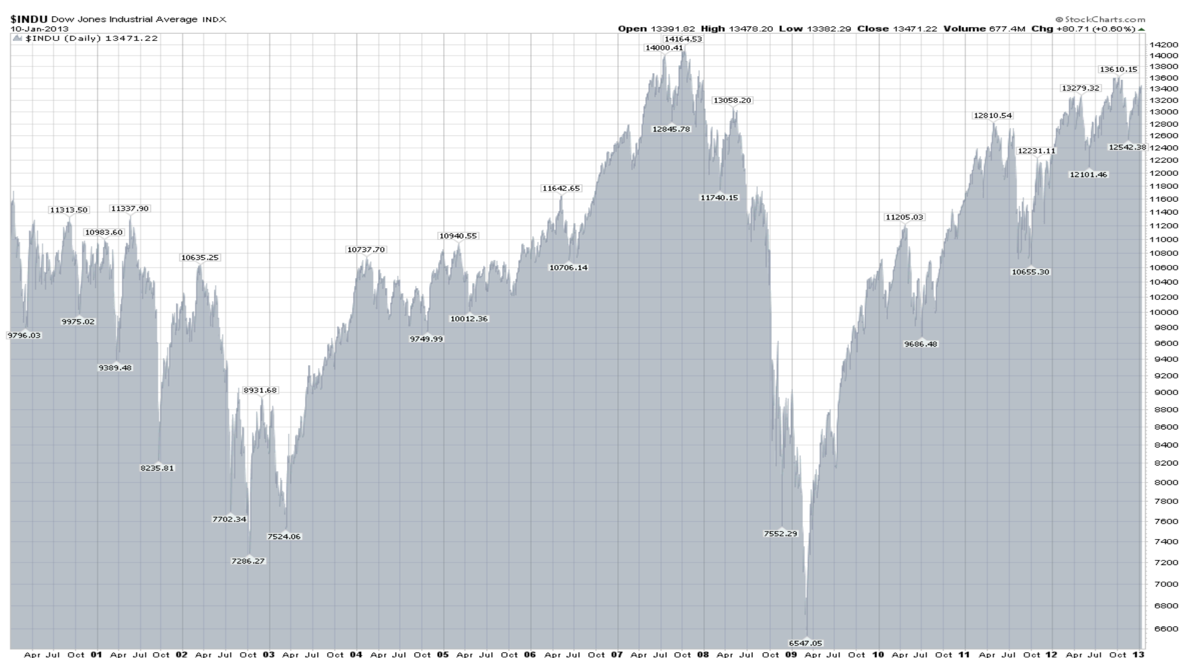


Fig. 3 describes an example of a long-term market overreaction. It is however also true that overreactions may occur on shorter time intervals.

There are two hypotheses to explain the abnormal price movements:

- Overreaction Hypothesis - according to this hypothesis, investors overreact in a given period, but the next period they act in opposite direction, i.e. if the price has increased one day, then the next day it will fall and vice versa;
- Under-reaction Hypothesis - investors underreact at event during the period of its appearance, however the next period they adjust actions - which means in case of some positive news price may not respond or even decrease, however the next day it will increase (Stefanescu et al. (2012)).

The overreaction hypothesis was first identified by De Bondt and Thaler (1985). De Bondt-Thaler's (DT) idea was based on Kahneman-Tversky's (1982) research who showed that investors overvalue the recent information and undervalue the past information.

The main conclusions of DT's research were that portfolios with the worst/best dynamics during three-year period prefer to show the best/worst results over the next three years. Such results were obtained by analyzing the investment portfolios on the New York Stock Exchange.

According to DT, profits can be obtained using the following trading strategy of buy assets that have lost in value and selling those that have grown in value. Defining parameters of this trading strategy, DT got the following results:

- Portfolios with results, worse than average during previous 3 years, showed a return over the next

36 months that exceeded the average market average on 19.6%.

• Portfolios with profits over-average during next 36 months, earn 5% less than the average market rate of return. [6]

Overreactions are associated with irrational behavior of investors who overreact on certain news, perceiving them too optimistic (pessimistic). This leads to significant deviations in prices of the asset from its fundamental value (price). Such overreaction leads to correction of prices in subsequent periods.

Interesting fact, mentioned by DT, is asymmetry of overreaction. The size of overreaction is bigger for undervalued stocks than for overvalued stocks. Another result of the DT's work is confirmation of the "January effect" - overreactions occur mostly in January.

After DT's (1985) publication, scientists from different countries conducted similar studies in terms of different time periods, markets and countries. Here are some examples of such researches.

• Brown-Harlow (1988) analyzed New York Stock Exchange data for the period from 1946 to 1983 and reached similar to DT conclusions.

• Zarowin (1989) showed the presence of short-term market overreactions.

• Atkins and Dyl (1990) investigated the behavior of common shares on the New York Stock Exchange after significant price changes in one trading day and found overreaction presence, especially in the case of falling prices.

• Ferri and C. Min (1996) confirmed the overreaction hypothesis on S&P 500 data for the period 1962-1991.

• Larson and Madura (2003) analyzed New York Stock Exchange data for the period from 1988 to 1998 and showed the presence of overreaction effect.

• Clements et al. (2007) also testified in favor of the overreaction hypothesis. Analysis of data during 1983-2007 showed that manifestations of overreaction effect become even more obvious nowadays.

Overreaction hypothesis was confirmed in different international stock markets, including Spain (Alonso and Rubio (1990)), Canada (Kryzanowsky and Zhang (1992)), Australian (Brailsford (1992)), (Clare and Thomas (1995)), Japanese (Chang et al. (1995)), Hong-Kong (Akhigbe et al. 1998)), Brazilian (DaCosta and Newton (1994), Richards (1997)), New Zealand (Bowman and Iverson (1998)), Chinese (Wang et al. (2004)), Greek (Anthoniou et. al., 2005), Turkish (Gülin Vardar & Berna Okan, 2008) and Taiwan (Lin (1988)).

Most of the researchers, as a research object, use stock markets (see the example above), however overreaction hypothesis was tested in other markets. In particular, the gold market (Cutler, Poterba, and Summers (1991)), option market (Poteshman (2001)).

The efficiency of the overreaction hypothesis was proved not only on theoretical and empirical level, but also in the sphere of real trading. For example, Jegadeesh (1993) developed a trading strategy based on the main provisions of the overreaction hypothesis. Strategy algorithm is quite simple and consists in opening transactions in direction, opposite to the previous movement. As the period of analysis Jegadeesh used month. So, after price on certain asset within a month increases, it should be sold and short position is held during the month.

Contrary actions are performed in case of price decreasing. Profitability of such strategy according to Jegadeesh is 2% per month. A similar strategy but with a period of a week, was developed by Lehmann (1990). The result was 2% return in a week. Such results indirectly evidence that overreaction hypothesis is not just a hypothetical construction, but is actually working and effective.

2.2 Reasons for overreactions

Despite a large number of scientific researches devoted to the problem of overreactions, there is no consensus about its causes. According to EMH, overreactions should not exist because they create opportunities to obtain extra profits.

However, current evidence is in favor of the overreaction hypothesis. Summarizing existing theories we can list the reasons for these overreactions as Psychological, Technical, Fundamental and other.

2.3 Psychological overreactions

Psychological overreactions are normally associated with the following:

• Overreaction to new information - Instead of comparing new information with existing information and taking rational decisions, investors act under emotions and the herd effect. (Griffin and Tversky (1992), Madura and Richie (2004)).

• Existence of "noise" traders - Irrational investors take investment decisions on fragmentary information and current price fluctuations. According to Aiyagari and Gertler (1999), one of the most common behavioral signs of noise traders is their attempt to sell, if current prices fall and buy if prices increase. Thus, their activity increases the price fluctuations in the markets.

Developing the idea of presence in the market different investors, Hong and Stein (1999) note the existence of two types of investors: those ones who trade on inside and private information ("newswatchers", investors who use fundamental analysis are the basis for investment decisions), the other ones take decisions based on past prices analysis and extrapolation its results on the future ("momentum traders", investors who use technical analysis as a base for decision-making).

Depending on dominating type of investor in the market, overreaction or under-reaction may occur. For example, technical analysts react to price fluctuations

very quickly, that leads to the overreactions, if they dominate in the market. Conversely, investors who use fundamental analysis are oriented over a longer time horizons. They respond to new information slowly. This can lead to under-reaction of the market for particular new information.

- The representativeness effect – If a particular market or market sector is growing rapidly for some time, it forms a positive image among investors. Accordingly, investors begin to prefer assets of this sector. In turn it leads to increase in demand and therefore price growth. Barberis, Shleifer and Vishny (1998) explain representativeness effect by the fact that investors often ignore the laws of chance and behave as if the events, that took place recently, are typical. However, they are very slow to change their previous views and beliefs in response to the emergence of new information.
- Psychological characteristics of investor's behavior, such as panic and the effect of the crowd - Typical human psychological flaws can explain why "rational" investors buy assets higher than their fundamental value and sell below their fair value.
- Overconfidence and biased attitude - Investors often overestimate their ability to analyze the market situation. In this regard, they underestimated the likelihood of errors in the prediction of a certain event. Usually it is associated with a certain experience which caused the illusion of market understanding.

Daniel et al. (1998) also names a biased attitude as a psychological feature. If some information confirms the predictions of investor, it strengthens his belief in own rightness. In addition, the investor's confidence decreases very slowly even if information begins to refute their predictions. In other words, there is a tendency to consider random success as own achievement and to think that mistakes are caused totally by the external factors, independent from investor.

2.4 Technical reasons

An important group of factors that can lead to the emergence of market overreactions are technical reasons, i.e. factors associated with the use of technical analysis by investors in making decisions. Technical analysis methodology is based on the previous price fluctuations in forecasts of future prices. It is widely believed that the current movement in the price of assets can generate specific trading signals from various technical indicators that will lead to massive operations/trading in the current movement direction and will strengthen it causing overreaction.

Another important technical factor is price behavior when it approaches "level" (term from technical analysis that characterizes certain price values which act as some sort of a barrier to the next movement, since interest of the market is generally concentrated in these price zones). "Level" breakthrough usually leads to massive operations in direction of current price movement.

One of the most important technical factors leading to overreactions is the execution of so-called "stop-losses" ("stops"). These are orders to close open positions when a certain level of losses is achieved (see Duran and Caginalp (2007)). Execution of stops means opening positions in the direction of current movement (forced closure of the short positions means opening of the long positions and vice versa). Stops execution acts as a movement catalyst or accelerator, and leads to increase in the scale of basic movement and loss of control over its size. The most typical example of overreaction caused by stops execution is the collapse of U.S. stock indexes in 1987 (Black Monday), when Dow Jones index lost 22.6%.

Analyzing the role of technical factors, Aiyagari-Gertler (1999) proposed an explanation for the emergence of overreactions called the margin-call theory. Its meaning is very close to previously analyzed stops execution. The bottom line of their idea is: to open a position on particular asset investors need cash collateral - margin. To increase clients' operations, increase their trading opportunities, brokers usually provide traders with the so-called leverage (some sort of a loan).

For example, with a $ 10,000 account trader can open positions on hundreds of thousands dollars. When position is opened certain amount of margin is needed and is reserved on the trade account. The consequence of this practice is an opportunity to make bigger profits, but bigger risks and losses too. At the same time, brokers, do not want to risk their own money (acting as a creditor of client's operations they share risks). So they limit the risks of the client using the margin-call mechanism.

Positions are closed when margin requirements reach certain level of equity (when trade account is insufficient to cover existing losses plus a certain level of margin). In case of large and unexpected movement in the markets margin-call mechanism often comes into action, closing the most unprofitable position of the client to release the margin. Closure of unprofitable positions means, that opposite positions are opened, i.e. positions in the direction of current movement, thus increasing its scale.

Margin-call theory has the right to life, especially in case of super-movements (as in 1929 or 1987 years), though there are doubts that in the case of "normal" overreactions this factor can be dominant.

2.5 Fundamental reasons

One more important group of factors is the fundamental ones such as the so-called "price-ratio hypothesis", proposed by Dreman (1982). According to this hypothesis, companies with low P/E ratio are undervalued. However, usually there are few investors who wish to buy stocks of these companies. It happens because past negative still strong in the memory of

investors. Nevertheless, when negative news on such companies end and positive news become dominant, the demand for shares increases dramatically. That leads to abnormal movements. Opposite situation is observed for overvalued shares.

2.6 Other reasons

Other reasons include the lack of liquidity in the market. Even small numbers and amounts of transactions can lead to significant price fluctuations (Jegadeesh-Titman (1992)).

Based on the analysis of the causes of market overreactions, the question arises that if an overreaction is not the result of achieving a new level of fair price, but rather a combination of psychological, technical and other non-rational factors, in this case at the end of overreaction, should prices correct to adjust equilibrium level? If it is so, the result should be that the size of countermovement in prices should exceed the size of countermovement for standard (normal, usual) periods.

Bremer and Sweeney (1991) proved the fact that after a very strong negative price movement positive price movement occurs. Their size exceeds ordinary movements. Analysis of negative daily changes which in size exceeded 10% showed that the next day price increased on average by 1.77%.

This phenomenon can be explained by:

- Fixation of profits - traders who open positions in the direction of the abnormal movement on the next day (realizing the fact that the potential of the movement is exhausted), close their positions to fix profits. To do this they have to open opposite positions and that initiates the movement in the opposite direction to the previous abnormal movement direction;
- Technical factors - after abnormally strong movements some technical indicators (especially oscillators) generate signals for transactions in a direction opposite to the previous abnormal movement;
- Market (rational) factors - investors reassess information and understand the fact of the previous movement abnormality, with further actions to return to its equilibrium level.

3 Research methodology

In this paper t-statistics is used to confirm/reject the fact that the size of counter-reaction that occurs after abnormal price fluctuations differs from the size of typical counter-movements (countermovement after usual, standard day, without any overreactions). The excess of the calculated t-test values over its critical value will indicate that presented data sets belong to different general populations. In practical terms this will mean that the size of countermovement that occurs after abnormal movements statistically differs from the normal countermovement. This, in turn, confirms the overreaction theory.

One of the conditions for the use of the t-test is the normality of the distribution of the analyzed data. Note that our sample is quite large in size (from a few hundreds to several thousands values). This allows us to use the central limit theorem and concludes compliance data to normal distribution (for details see Mendenhall et al. (2003)).

However, in order to confirm above-mentioned logical assumptions, we will analyze the "normality" of our data using specially designed criterion.

Normal distribution, so-called Gaussian distribution, is the probability distribution, under which the resulting value is affected by a large number of random factors.

Central Limit Theorem: If a random variable is exposed to an infinite number of infinitely small random factors, it is normally distributed.

Random variable is a variable which value results from the measurement of a quantity that is subject to variations due to chance (i.e. randomness, in a mathematical sense).

There are many factors that affect the movement of market prices and their influence is very different. So the price movement assumes the character of random fluctuations (usually for a limited period of time). Thus, financial assets prices can be regarded as random variables.

In order to check data, we used the Pearson criterion. We randomly selected 100 consecutive ranges of prices for the period 2006-2008 (Table 1) and calculated values of test statistics. If test statistics does not exceed the critical value of chi-square distribution, the value is normally distributed.

Table 1. "Normality" of EUR/USD data

	2006	2007	2008
Number of values	100		
Average	80.14	73.62	145.19
Standard deviation	28.37	24.5	51.67
Confidence probability	0.95		
Test statistics	6.1	9.37	9.12
Chi-square distribution (hi(p=0.95, f=7))	14.1		
Conclusion	Data is normally distributed		

Thus, daily ranges of financial assets prices changes are normally distributed. So the data is relevant to use Student's t-test.

The next important thing is data sample formation. The principal moment here is the interpretation of overreaction.

We will analyze short-term overreactions, so the period of analysis will be 1 day (one trading session). Typical price parameters that characterize the behavior of prices during one day are: maximum price, minimum price, open and close price.

In most studies to measure the size of price movement the difference between the open and close price is used. This is the final size of price changes over one day - daily return.

However, we believe this approach is not adequate enough and does not reflect real events fully. There are a lot of overreactions (when price during one day deviates strongly) with small price between open and close prices. So, we propose to consider daily return as the size of the fluctuations in price during the day, i.e. the difference between the maximum and minimum prices during the day.

It should be noted that in most cases, to calculate the size of overreaction and daily return relative values are used. An alternative to this approach is calculation of the movement size in absolute values.

Anyway, as the use of relative values let us avoid the impact of changes in absolute size of daily ranges due to the price changes (for example, when prices grow the absolute size of fluctuations also increases) we consider relative values more correct and adequate.

So the formula for calculating the daily return will be:

$$R_i = \frac{(High_i - Low_i)}{Low_i} \times 100\% \tag{1}$$

where R_i - daily return % for day *i*;

$High_i$ - maximum price for day *i*;

Low_i - minimum price for day *i*.

The next important step is to define the criteria for overreaction. Which daily return is normal, and which is abnormal (overreaction period)? We offer 3 variants for the overreactions defined.

1) If current daily return exceeds the average plus one standard deviation then this day is concerned to be a day of overreaction

$$R_i > (\overline{R}_n + \delta_n) \tag{2}$$

where $\overline{R}_n$ - average size of daily returns for period *n*.

$$\overline{R}_n = \sum_{i=1}^{n} R_i / n \tag{3}$$

δ_n - standard deviation of daily returns for period *n*

$$\delta_n = \sqrt{\frac{1}{n}\sum_{i=1}^{n}(R_i - \overline{R})^2} \tag{4}$$

2) if current daily return exceeds the average plus two standard deviations then this day is concerned to be a day of overreaction

$$R_i > (\overline{R}_n + 2 \times \delta_n) \tag{5}$$

3) if current daily return exceeds the average plus three standard deviations then this day is concerned to be a day of overreaction

$$R_i > (\overline{R}_n + 3 \times \delta_n) \tag{6}$$

Period of averaging will be determined during the data analysis.

Thus, if the size of daily return of the test period exceeds the given parameters, it is considered abnormal. Accordingly this day is the day of overreaction and the next day should be the day of abnormal counter-reaction (at least this hypothesis will be checked).

The next step is to determine the size of counterreaction. We suggest determining it as the relative difference between the open price the next day and the maximum deviation from it in the direction opposite to the price movement on the overreaction day.

If price increased, during the overreaction, then the formula for counterreaction size calculation is:

$$cR_{i+1} = 100\% \times \frac{(Open_{i+1} - Low_{i+1})}{Open_{i+1}} \tag{7}$$

where cR_{i+1} - counterreaction size

$Open_{i+1}$ - open price of the day next to day of.

If price decreased, during the overreaction, then the formula for counterreaction size calculation is:

$$cR_{i+1} = 100\% \times \frac{(High_{i+1} - Open_{i+1})}{Open_{i+1}} \tag{8}$$

The result of calculations will be formation of two data sets:

Set 1. Size of counterreactions after normal price fluctuations

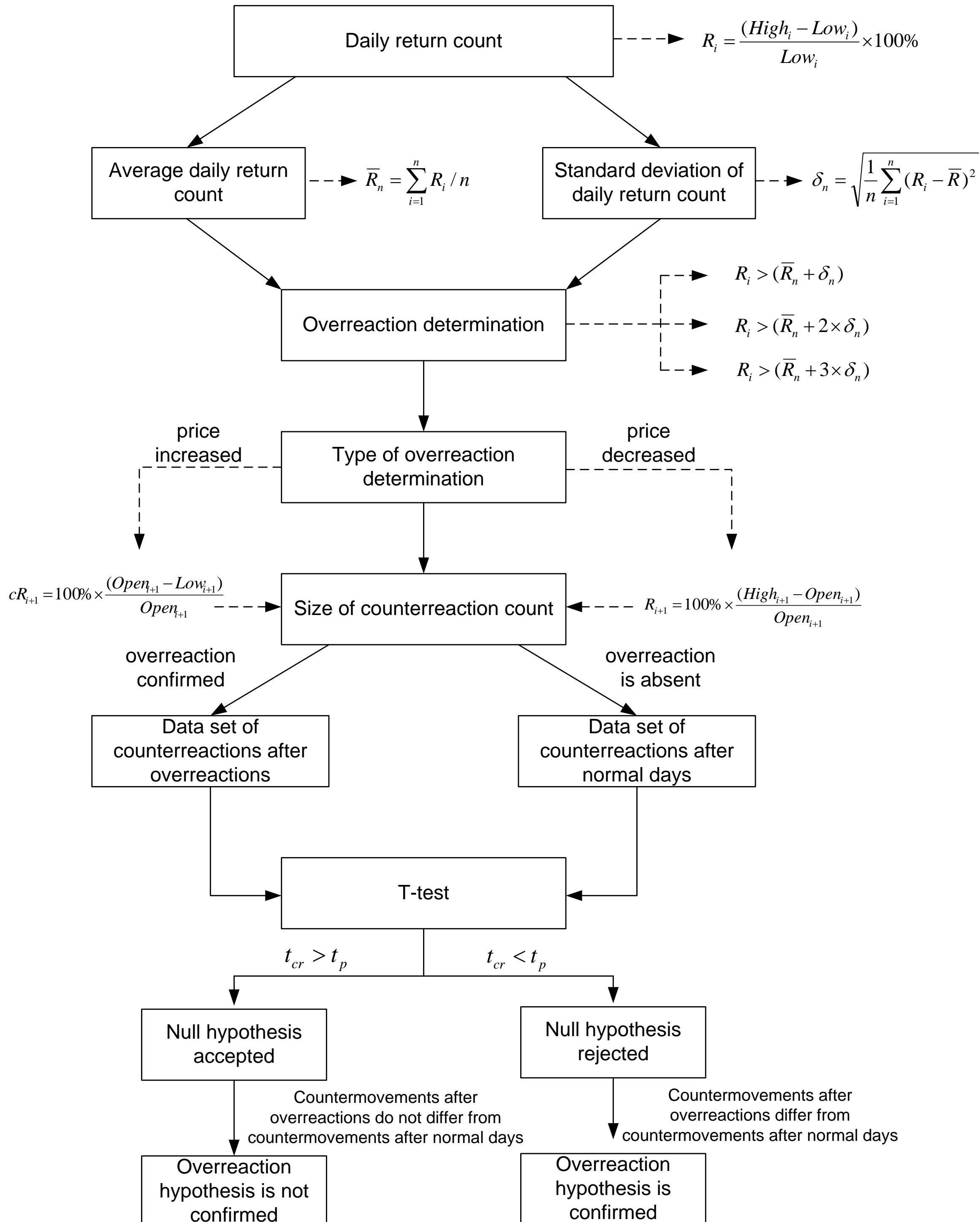
Set 2. Size of counterreactions after abnormal price fluctuations

The aim of research is to test these two data sets for their conformity to the same general population. If they match, overreactions hypothesis is not confirmed. Otherwise, if these arrays belong to various general populations, the overreaction hypothesis is confirmed and the fact that abnormal price movements generate abnormal countermovement is also proved. Checking for compliance will be done using Student's t-test.

The null hypothesis in this case is: two sets belong to the same general population. If t-critical exceeds t-calculated, the null hypothesis is accepted otherwise – it is rejected (that means that data sets belong to different general populations).

The algorithm of our methodology is as follows:

Figure 4. The algorithm of our methodology



4 Findings

As objects of analysis we choose the following financial assets:

- Dow-Jones index (developed stock market);
- Currency pair EURUSD (FOREX);
- Gold (commodities);
- Oil (commodities);
- UX index (leading Ukrainian stock market index - emerging stock market).

Test results for these assets are presented in Appendices 1-5. Results are rather sensitive to the parameters of testing (period of averaging and criterion of normality – the number of standard deviations that should be added to the mean). That is why they are mixed.

Interesting result of analysis is conclusion that increased size of abnormal movement does not necessary lead to increased size of countermovement.

Let's discuss results of analysis in details (case of Dow-Jones index for the period 1987-2012). We choose Dow-Jones index because US stock market is the biggest and developed in the world. Plus it has the biggest number of participants and the highest level of exchange culture in general.

The number of abnormal returns detections during 1987-2012 is presented in Table 2.

Table 2. The number of abnormal returns detections in Dow-Jones index during 1987-2012

n	5		10		20		30	
Indicator	Number	%	Number	%	Number	%	Number	%
Overall	6458	100	6454	100	6444	100	6434	100
Number of abnormal returns (criterion - mean+sigma)	1297	20	1183	18	1123	17	1070	17
Number of abnormal returns (criterion - mean+2*sigma)	587	9%	474	7	379	6	371	6
Number of abnormal returns (criterion - mean+3*sigma)	290	4%	194	3	159	2	145	2

As we can see, both parameters (period of averaging and number of standard deviation added to mean) make impact on the number of detected anomalies. It should be mentioned that change of averaging period causes relatively small deviations of the number of detected anomalies (difference between number for the period=5 and period=30 is less than 10%). So period of averaging is not so important from the position of number of detected anomalies. That is why selection of averaging period may be depended on other factors that interest researcher.

Opposite situation is observed for the parameter that concerns the number of standard deviations should be added to mean to detect the anomaly.

Each additional standard deviation significantly decreases the number of observed abnormal returns (the size of decrease is 50% for each additional sigma). It creates strong restrictions for the practical use of this parameter. 2-4% of overall data sample (the number of abnormal returns in case of 3 sigmas) are not enough to create a representative population and to make reasonable conclusions.

Based on data from Tables A.1-A.4 we selected the next set of parameters: period of averaging = 30, the number of sigmas = 1. This selection is caused by the following reasons:

1) Results for different types of market are close to each other with this combination of parameters;

2) Small periods of averaging cause serious fluctuations in values of means and standard deviations that increases the level of "noise" in data and results;

3) Increased number of sigmas significantly reduces the number of detected anomalies;

4) The quality of results is the highest for this set of parameters (difference between normal countermovements and countermovements after abnormal returns).

Results of analysis for this set of parameters are presented in Table 3.

The results of empirical tests evidence are in favor of the statistically significant difference between the size of countermovements after "normal" returns and the size of countmovements after abnormal returns. The only exception among analyzed types of financial markets is foreign exchange market (case of EURUSD). In case of FOREX difference between the size of countermovements after "normal" returns and the size of countermovements after abnormal returns is statistically insignificant (means are 0,5 and 0,52 accordingly). So for the FOREX null hypothesis is accepted. These results are consistent with EMH. So it is impossible to get extra profits from trading on foreign exchange market using the contrarian trading strategy based on short-term overreactions.

For other types of financial markets (stock and commodities) difference between means (let's call it "delta") is nearly 10% and it is statistically significant (t-criterion is bigger than t-critical). Nevertheless "delta" is different for each type of markets and assets. Maximum difference between "normal" average and "abnormal" was observed in Ukrainian stock market (1.07% vs 1.79%). "Delta" exceeds 50%. This gives huge opportunities for

speculative transactions based on contrarian trading strategy.

Table 3. Results of null hypothesis testing for different types of financial markets and assets (period of averaging=30, number of sigmas=1)

Type of financial market	Commodities market				Stock market				Foreign exchange market	
Type of asset	Gold		Oil		UX index		Dow-Jones index		EURUSD	
Indicator	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	726	3583	693	3816	142	790	1070	5364	952	5164
Mean	0,73%	0,66%	1,64%	1,50%	1,79%	1,07%	1,09%	0,92%	0,52%	0,50%
Standard deviation	0,72%	0,71%	1,48%	1,42%	2,11%	1,14%	1,12%	0,77%	0,44%	0,43%
t-criterion	2,74		2,49		4,10		4,72		1,12	
t-critical (p=0.95)	1,96									
Null hypothesis	rejected		rejected		rejected		rejected		accepted	

US stock market demonstrates the second biggest "delta". Average size of delta for Dow-Jones index is less than 20%. Anyway this difference is statistically significant that gives opportunities for successful trading on overreaction.

Thou, stock markets are the most sensitive to overreactions and further countermovements among other types of financial markets.

For commodities markets "delta" equals 10% on average and is statistically significant. This let us make a conclusion that countermovements after "normal" and "abnormal" returns are different. Also we should point out that the size of countermovement after "abnormal" returns for Oil is the biggest after Ukrainian stock market.

In general, results evidence in favor of less efficiency of the Ukrainian stock market (comparing with US stock market or other types of financial markets) and it's high speculative potential (size of countermovements in Ukrainian stock market is almost 2 times bigger than in US stock market).

These facts allow extra profit obtaining from the trading on Ukrainian stock market.

Based on results of research we can recommend the following rules of trading on short-term market overreactions:

1) detection of anomaly (abnormal return) – as a criterion can act exceeding of current range of fluctuation over certain value (according to our results this value is mean with a period of averaging 30 plus 1 standard deviation);

2) in case of detection of anomaly the next day position opposite to previous abnormal movement should be opened;

3) after reaching the target price (average size of countermovement for certain type of asset or market) open position should be closed.

Of course these rules are common and should be specified in the process of backtesting of strategy based on them.

5 Conclusions

In general results of research on the stock and commodities markets are consistent with the overreaction hypothesis. Results for FOREX are consistent with EMH. The results are rather sensitive to the set of parameters of testing. That is why they should be interpreted with the reference to the set of used parameters. Nevertheless, results of analysis evidence in favor of temporary inefficiencies in activities on stock and commodities markets.

We find significant evidence of overreactions in Ukrainian stock market using the daily data over the period 2008-2012. Results show that the size of contrarian price movements in Ukrainian stock market is higher than in US market. Comparing results from Ukrainian stock market with other financial markets we conclude that there is a high speculative potential on the Ukrainian stock market and also that the Ukrainian stock market is less efficicient. Low level of market efficiency gives opportunities for extra profits.

Based on results of research we recommend some rules of trading on short-term market overreactions. Our study also makes some contribution to the overreaction hypothesis literature. First, we provide evidence of abnormal counter-reactions after the overreactions on Ukrainian stock market. These results are consistent with overreaction hypothesis. Second, we find practical implication to the overreaction hypothesis on the Ukrainian stock market - rules of trading on short-term market overreactions. Third, analysis of different financial markets with the same methodology let us make

complex conclusions about the presence of short-term market overreactions in modern financial markets and to highlight markets immune or exposed to overreactions.

6 Summary

This paper investigates whether counter-movements after days with abnormal returns are larger than countermovement after "normal" days.

Our results, based on daily data from US stock market, FOREX, commodities and Ukrainian stock market, indicate the following:

Firstly, the behavior of the stocks and commodities markets is consistent with the overreaction hypothesis and evidence in favor of temporary inefficiencies in activities on stock and commodities markets.

Secondly, the results for FOREX are consistent with EMH.

Thirdly, the results are rather sensitive to the set of parameters of testing. That is why they should be interpreted with the reference to the set of used parameters.

Fourthly the size of contrarian price movements in Ukrainian stock market is higher than in the US market. Comparing results from Ukrainian stock market with other financial markets we come to conclusion about the less market efficiency of the Ukrainian stock market. Low level of market efficiency gives opportunities for extra profits.

Finally, the important conclusion of this research is the high speculative potential of the Ukrainian stock market. Results of this paper can be a good base for construction a contrarian trading strategy based on short-term overreactions analysis. Basics of such strategy were proposed in this paper.

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Appendix A

Table A.1. Test results for Dow Jones Industrial Average Index for the period 1987-2012

1 sigma

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	1297	5161	1183	5271	1123	5321	1070	5364
Mean	0,97%	0,95%	1,00%	0,94%	1,06%	0,93%	1,09%	0,92%
Standard deviation	0,97%	0,80%	1,01%	0,80%	1,08%	0,78%	1,12%	0,77%
t-criterion	0,859571855		2,033267584		4,230763317		4,722439164	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		rejected		rejected		rejected	

2 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	587	5871	474	5980	379	6065	371	6063
Mean	1,01%	0,95%	1,07%	0,94%	1,14%	0,94%	1,20%	0,94%
Standard deviation	1,14%	0,81%	1,26%	0,80%	1,39%	0,79%	1,41%	0,79%
t-criterion	1,414756929		2,282117763		2,764405498		3,545822771	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		rejected		rejected		rejected	

3 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	290	6168	194	6260	159	6285	145	6289
Mean	1,07%	0,95%	1,10%	0,95%	1,29%	0,94%	1,52%	0,94%
Standard deviation	1,39%	0,81%	1,57%	0,81%	1,84%	0,80%	1,99%	0,79%
t-criterion	1,477631306		1,384190797		2,367443946		3,482152514	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		rejected		rejected	

Table A.2. Test results for the UX index for the period 2009-2012

1 sigma

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	180	777	164	788	154	788	142	790
Mean	1,43%	1,14%	1,54%	1,13%	1,71%	1,08%	1,79%	1,07%
Standard deviation	1,94%	1,29%	1,95%	1,30%	2,05%	1,23%	2,11%	1,14%
t-criterion	2,036494236		2,725513425		3,762167756		4,096163334	
t-critical (p=0.95)	1,96							
Null hypothesis	rejected		rejected		rejected		rejected	

2 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	73	884	85	867	72	870	66	866
Mean	1,39%	1,17%	1,67%	1,15%	2,02%	1,12%	2,04%	1,11%
Standard deviation	1,77%	1,40%	2,22%	1,34%	2,36%	1,29%	2,06%	1,27%
t-criterion	1,051742909		2,128155584		3,2381263		3,650673714	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		rejected		rejected		rejected	

3 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	31	926	43	909	35	907	27	905
Mean	1,46%	1,18%	1,41%	1,19%	1,78%	1,17%	2,39%	1,14%
Standard deviation	1,98%	1,40%	1,91%	1,42%	2,20%	1,37%	2,28%	1,31%
t-criterion	0,789177573		0,756710393		1,648250598		2,843550605	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		rejected	

Table A.3. Test results for the currency pair EURUSD for the period 1989-2012

1 sigma

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	1267	4875	1074	5062	1006	5120	952	5164
Mean	0,97%	0,95%	0,50%	0,51%	0,50%	0,51%	0,52%	0,50%
Standard deviation	0,97%	0,80%	0,42%	0,43%	0,43%	0,43%	0,44%	0,43%
t-criterion	0,849572618		-0,860344841		-0,310513198		1,120110619	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		accepted	

2 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	629	5513	454	5682	374	5752	334	5782
Mean	1,01%	0,95%	0,49%	0,51%	0,52%	0,50%	0,55%	0,50%
Standard deviation	1,14%	0,81%	0,43%	0,43%	0,43%	0,43%	0,44%	0,43%
t-criterion	1,464495703		-0,766391672		0,625074255		1,921197517	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		accepted	

3 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	355	5787	206	5930	144	5982	126	5990
Mean	0,97%	0,95%	0,54%	0,50%	0,59%	0,50%	0,64%	0,50%
Standard deviation	0,97%	0,80%	0,47%	0,43%	0,45%	0,43%	0,47%	0,43%
t-criterion	0,449703612		1,08240839		2,208156707		3,263013086	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		rejected		rejected	

Table A.4. Test results for gold for the period 1996-2012

1 sigma

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	886	3448	807	3522	745	3574	726	3583
Mean	0,65%	0,67%	0,68%	0,67%	0,72%	0,66%	0,73%	0,66%
Standard deviation	0,64%	0,72%	0,66%	0,72%	0,69%	0,71%	0,72%	0,71%
t-criterion	-1,334982129		0,686034132		2,191599044		2,742147192	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		rejected		rejected	

2 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	398	3936	315	4014	271	4048	255	4054
Mean	0,62%	0,67%	0,63%	0,67%	0,68%	0,67%	0,74%	0,67%
Standard deviation	0,58%	0,72%	0,61%	0,71%	0,70%	0,71%	0,79%	0,70%
t-criterion	-1,815892765		-1,388517607		0,210430638		1,481041542	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		accepted	

3 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	189	4145	105	4224	59	4260	55	4254
Mean	0,54%	0,68%	0,62%	0,67%	0,81%	0,67%	0,87%	0,67%
Standard deviation	0,51%	0,71%	0,62%	0,71%	0,95%	0,70%	0,97%	0,70%
t-criterion	-3,77366079		-0,849613628		1,184316079		1,515310007	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		accepted	

Table A.5. Test results for oil for the period 1995-2012

1 sigma

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	909	3625	776	3753	716	3803	693	3816
Mean	1,51%	1,52%	1,56%	1,51%	1,59%	1,51%	1,64%	1,50%
Standard deviation	1,39%	1,44%	1,47%	1,42%	1,46%	1,42%	1,48%	1,42%
t-criterion	-0,100474427		1,027787923		1,593035355		2,493366194	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		accepted		rejected	

2 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	430	4104	333	4196	260	4259	233	4276
Mean	1,50%	1,52%	1,58%	1,51%	1,73%	1,51%	1,79%	1,51%
Standard deviation	1,36%	1,44%	1,47%	1,43%	1,55%	1,42%	1,64%	1,42%
t-criterion	-0,327743331		0,771770513		2,298565501		2,68803689	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		rejected		rejected	

3 sigmas

	5		10		20		30	
	abnormal	normal	abnormal	normal	abnormal	normal	abnormal	normal
Number of matches	208	4326	138	4391	111	4408	107	4402
Mean	1,52%	1,52%	1,46%	1,52%	1,85%	1,51%	1,93%	1,51%
Standard deviation	1,19%	1,44%	1,30%	1,43%	1,56%	1,42%	1,57%	1,43%
t-criterion	0,000530744		-0,525812924		2,258133103		2,725251584	
t-critical (p=0.95)	1,96							
Null hypothesis	accepted		accepted		rejected		rejected	

CRISIS AND CONTROLS: THE ITALIAN MODEL

Roberta Provasi*, Patrizia Riva**

Abstract

The success of any Restructuring Technique is related to the quality of operations that the company has planned to implement. This is the reason why, no matter which of the recovery strategy the company choses, the law requires that more than one Independent Auditor should analyze the prospective financial data produced by the company and coming as a result of the planned restructuring operations.

Keywords: Traditional Italian Model; Corporate Governance; Supervisory Board; Statutory Board of Auditors; Collegio Sindacale*;* Auditor; Audit; Assurance; Independent Expert; Attestatore*;* Court; Pre-insolvency Agreements; Recovery and Resolution Plan; Restructuring Agreement; Crisis; Bankruptcy Law; Insolvency; Turn Around; Flow of Information

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1 Restructuring techniques recently introduced in the Italian law and the renewed need of controls

The reform of Italian Bankruptcy and Business Recovery Law was introduced in 2005 and then reviewed more than once (Paluchowski-Pajardi 2008; Riva 2009; Scarso 2009, Quagli-Danovi 2012). It has deeply changed the philosophy and the basics of the country's business recovery procedures. The new regulations discipline has introduced tools that are oriented toward the maintenance and recovery of the company by agreements' estimation between creditors and entrepreneur, with a greater involvement of the former in management of the crisis (Corno 2009, Provasi-Riva 2013).

To counter the difficulties of the crisis, the government has introduced some specific instruments: Recovery and Resolution Planning (piano attestato ex art. 67 If), Restructuring Agreement (accordo di ristrutturazione ex art. 182 bis), Pre-insolvency Agreements (concordato preventivo ex art. 160 If). These techniques form a continuum based on the degree of judicial intervention and the degree of formality in general (Garrido 2011). Ideas to shape them come from the US Chapter 11 tradition (Stanghellini 2007; Ganuardi 2007, Riva 2001, 2009; Graham-Carmichael 2012) and from United Nations Commission on International Trade Law's (UNCITRAL's 2004) Legislative Guide to the Insolvency Law.

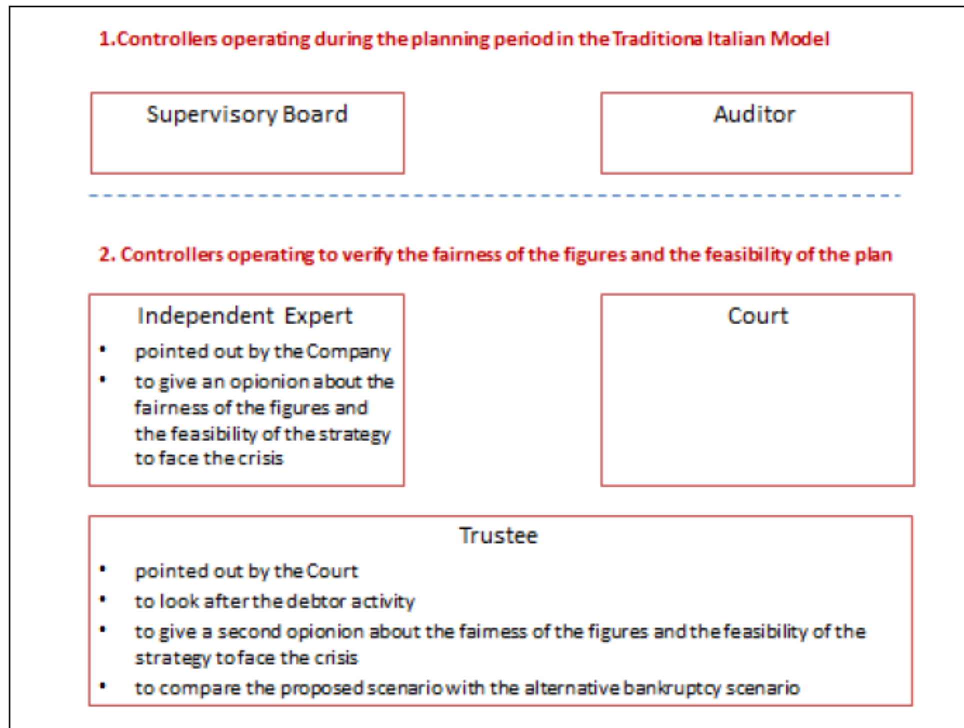
The focal point is that restructuring can help to preserve the business value of debtor enterprises, the interests of other stakeholders and the benefit of creditors as a whole (Guatri 1995). According to the UNCITRAL Legislative Guide (2005), all debtors that falter or experience serious financial difficulties in a competitive marketplace should not necessarily be liquidated; a debtor with a reasonable survival prospect (such as one with a potentially profitable business) should be given the opportunity to demonstrate that there is a greater value (and, by deduction, greater benefit for creditors in the long term) in maintaining the essential business and other component parts of the debtor.

Restructuring and reorganization proceedings are designed to give to the debtor some breathing space to recover from its temporary liquidity difficulties or more permanent over-indebtedness and, as necessary, provides the debtor with an opportunity to restructure its debt and its relations with creditors. If reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of its claims (Riva 2009, Provasi-Riva forthcoming).

The success of any Restructuring Technique is related to the quality of operations that the company has planned to implement. This is the reason why, no matter which of the three new instruments the company choses, the law requires that more than one Independent Auditor should analyse the potentially prospective financial data produced by the Recovery Strategy. Different specific opinions are required about the feasibility of the project and the fairness of the expected figures. In recovery and resolution planning (art. 67 lf) and in restructuring agreement (art. 182 bis lf) these are expressed by an Independent

Expert pointed out by the company, while in pre-insolvency agreements with creditors (art. 160 lf) a second opinion is needed from the Trustee pointed out by the Court. In addition the situation is continuously monitored by the Supervisory Board (Collegio Sindacale), sometimes called Statutory Supervisory Board, the specific watchdog distinguishing the Italian corporate governance system (Stiglitz, 2009) and - depending on the company's size - by the Auditor .

Figure 1. Controls and controller in the crisis



In crisis context timing represents a critical variable to be carefully considered and managed. To get the best results for the company, a good flow of information should be created among the independent experts involved in the process. Being able to walk through the documentation of the Corporate Controllers would be in fact of great help for the Independent Expert exam of the fairness of the figures, and can reduce the timing of his audit work. Unfortunately in the Italian context this is not always possible as our empirical research points out.

2 The specificity of Italian system control: the supervisory board (Collegio Sindacale)

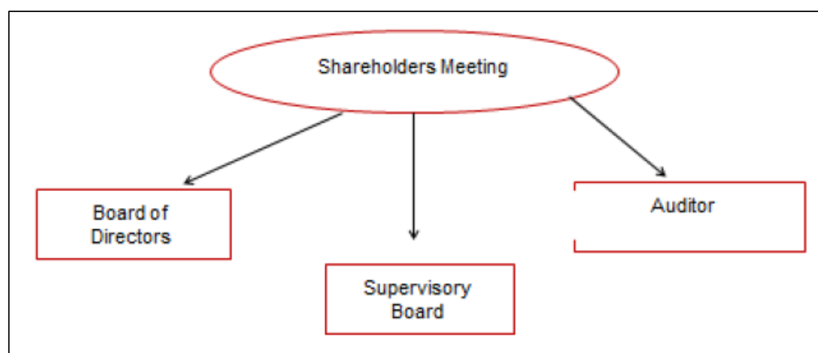
The Supervisory Board (Collegio Sindacale), sometimes called Supervisory Board is the characteristic of Italian system according to the Traditional model of corporate governance provided for by the Italian law. With the enactment of the Commercial Code in 1882 it was introduced a supervisory organ for the compliance control to the law, to the Constitution and to the Statute of the company because after the abolition of Government Supervision it was necessary to entrust the fate of a company not entirely to administrators, whose activity in reality should be controlled to protect the interests of the company, its shareholders and all the stakeholders.

In fact, among the functions of the Supervisory Board must be emphasized the protection of all the interests. Over time through the different European Directives the Auditor has achieved a substantial improvement especially of quality defects and malfunctions. In particular self-regulation represented by code of conduct issued by National Board of Certified Public Accountants allowed exceeding regulatory gaps relating to the demarcation between the functions of administrative and accounting control.

The administration and control system called "Traditional", as an alternative to the one- tier and two-tier corporate governance model, is the prevalent one in the Italian context. According to article 2380 of the Civil Code the "Traditional" model constitutes the natural system of corporate governance for the management of Italian firms, the application of the two alternative models must be expressly provided in a special provision of the company's Statute. The structure of this model provides an administrative board appointed by Shareholders which is responsible for the management of the company, the Supervisory Board again appointed by Shareholders that carries out the control over the administration and the

external Auditor also appointed by Shareholders which is responsible for the auditing .

Figure 2. Italian Corporate Governance Structure "Traditional Model"



This model allows a precise division of roles: the administrative function is clearly separated from the control function. The Supervisory Board appointed by shareholders is made up of 3 or 5 effective members (plus 2 temporary auditors). One effective member and one temporary Auditor should be enrolled in the register of Auditors. Since the introduction of the Reform of Company (Legislative Decree N. 6, January 17, 2009) the Supervisory Board is responsible to supervise[1]:

− the observance of the law and the Statute, the Supervisory Board should verify the compliance of acts and resolutions to the provisions of both law and statute;

− the conformity of the management decisions to criteria of rationality (efficiency and effectiveness of choices) and if management has considered all the information necessary for taking operational decisions;

− the adequacies of the organizational structure that must be suitable to the size, to the nature of the operations and to the strategies planned to achieve corporate purposes.

There is no doubt that the Supervisory Board represents an important element of the Italian experience that should be emphasized in international contexts. The great crisis that has hit the world economy since 2008 could have been avoided if more companies would have adopted an adequate internal control system to ensure the protection of the social interest performing their duties. This hypothesis is supported by a study carried out by the Aristeia Foundation, the Research Institute of Italian Chartered Accountants. Even Joseph Stiglitz - Nobel Prize for economics 2001 - highlighted the criticality and riskiness of governance models based only on external auditor (typical of Anglo-Saxon models) praising the Italian model based on the structural presence of a typical internal control body that is the Supervisory Board. The members of the Supervisory Board attend the assembly of the Board of Directors assisting directly to the decision making processes and stepping in meanwhile things happen. On the contrary External Auditors operate when everything has already been decided or even implemented. The peculiarity of the Italian System Controls is the joint existence of two levels of controls. A "downstream" control carried out by Auditors in charge of the accounting control and an "upstream" control carried out by the Supervisory Board in charge for the surveillance of managements behavior. In small companies the Supervisory Board can undertake both roles.

3 Controls and controllers in the crisis

In the Italian Model the Controllers operating while the company is trying to solve the crisis it has incurred in are, in more complex situation, the five depicted *supra* in Figure 1) which represents the typical scheme of Pre-insolvency Agreements *(concordato preventivo ex art. 160 lf).* The number of Controllers can shrink up to three in Recovery and Resolution Planning *(piano attestato ex art. 67 lf),* which is the Out of Court way to face insolvency.

3.1 Supervisory Board (Collegio Sindacale)

In March 2011, the CNDCEC (National Council of Certified Public Accountants) in reorganization of the professional standards for the supervision, also to receipt the recent regulatory changes introduced by Legislative Decree no. 39/2010, approved the Rules of Conduct of the Supervisory Board no. 9, no. 10 and no. 11. In particular the new provisions contained in the Rules of Conduct no.11 analyzes the behavior that the Supervisory Board must implement during the period of crisis according the functions assigned to it by law including business continuity testing and

[1] According to Art. 2403 Civil Code, " The Supervisory Board oversees compliance to the law, to the company's Statute to the principles of good management and the adequacy of the organizational, administrative and accounting procedures adopted by the company during its functioning".

the analysis of the adequate tools to establish a negotiation procedures for resolution of corporate crisis. This new Rule of Conduct is very important as it fills the legal vacuum of the Code. The Civil Code in fact merely outline the behavior of the Supervisory Board concerning corporate losses (art. 2447 c.c.) and liquidation (art. 2485 c.c.) while the Bankruptcy Law just consider the contexts in which the members of the Supervisory Board may be subject to an action for damages by the curator (trustee in bankruptcy) (art. 146 LF) or be involved in bankruptcy offenses (art. 223 LF).

Rules of Conduct standard no. 11 highlights the correct behavior of Supervisory Board from the first signs of the company crisis to when they attempt a negotiated solution, until the bankruptcy proceedings.

The state of crisis is undoubtedly one of the most serious evils that can affect the company; companies can get out of the crisis without consequences or the crisis can lead to premature death of the enterprise. The Italian legislature hasn't provide any definition of the corporate crisis, while the Courts have expressed by defining both the status of crisis and the status of insolvency. According to most shared approaches, status of crisis usually precedes but not necessarily the status of insolvency, which is part at a later time.

The Rule of Conduct no. 11 provides that the Supervisory Board in the performance of its functions, it must report to the administrative board about situations that could compromise the business continuity, suggesting where it is practicable, statutory tools provided by bankruptcy law to deal with the crisis situations. In particular, the Rule no.11 provides that the Supervisory Board gives a time limit to the administrative body to identify the more appropriate intervention actions to resolve the situation, unlike in extreme cases it may be the complaint to the Court according to the article 2409 of the Civil Code This is because "the time" plays a key role in finding a solution to the company's crisis. The timeliness in deciding and in taking the most suitable actions allow the preservation of key assets such as goodwill, order backlog, human resources, finance leases and to avoid or delay aggressive actions by creditors. The Supervisory Board must:

Table 1. Rule of Conduct no. 11.1 – Prevention and emergence of the crisis

1)	Inform directors when it has identified facts which may impair the business continuity
2)	Invite directors to identify appropriate intervention measures
3)	In case of unjustified delay or omission of Directors, the Supervisory Board shall convene the assembly to inform shareholders about the situation of crisis and the omission of directors (according to art. 2406 c.c.)
4)	In case of Directors' inaction the Supervisory Board can directly propose a procedure of negotiating composition of the crisis introduced by Bankruptcy Law: recovery and resolution planning (art. 67 lf) and in restructuring agreement (art. 182 bis lf) pre- insolvency agreements with creditors (art. 160 lf)
5)	In case of suspect that Directors could have done serious irregularities in management that can damage the company, they shall report to the Court.

The Rule no.11 has fueled thoughts on the much debated issue in the literature, the ability of the Supervisory Board to carry out a substantive control to the company's operations put in place by the administrative body. This kind of control in accordance to the provisions of the law may be "preventive" in accordance to 2403-bis and 2409-septies c.c., "informative" to art. 2381 c.c. and "reactive" to art. 2406 c.c., as well as "purposive" according to the articles 2441, sixth paragraph, article 2433-bis, 2378 fourth paragraph and 2409-quater cc. However, the doctrine seems to agree that carrying out a substantive control does not mean checking the quality or appropriateness of corporate operations but only to control the economic management criteria.

Table 2. Types of controls provided by Supervisory Board

Preventive control	Art 2403-bis and 2409-septies related to the control of management to search information that is not properly reflected in the financial statement.
Information control	Art. 2381 c.c. administrators should regularly inform the Supervisory Board on the general performance of the business and its outlook as well as the most significant transactions made by the company and its subsidiaries
Reactive control	According to Art 2406 c.c the convocation of meeting's shareholders, Art. 2408 c.c investigation of the facts reported by the shareholders, art. 2409 c.c the Complaint to the Court.
Proactive control	Art. 2441, sixth paragraph, 2433-bis, 2378 fourth paragraph, 2409- quarter c.c opinions issued by its report.

i. Conduct rule no. 11.3 - Role in Recovery and Resolution Plan (art. 67 l. f.) If the Shareholders Meeting adopts decisions to address the status of difficulty the Supervisory Board should always check whether they are the most suitable to overcome the crisis. Often the preferred option, especially in period of financial crisis, is the decision for the implementation of a Recovery and Resolution Plan that is the Out of Court Agreement with the creditors. Such an agreement could have the purpose to spread payments to suppliers, to reform the banking conventions deferring the payment of mortgage payments, dividing into installments the payment of insurance contributions or reducing the total amount of debts asking the approval for the payment of a percentage in settlement and in write-off. The advantages of such agreements are represented by their convenience and the simplicity by the saving intervention costs of professionals and the speed of the transaction conclusion. The drawbacks are, however, of various natures. All creditors must adhere to and if there is someone who may disagree, it's necessary to comply with him the agreed terms of payment. The transactions that took place in the out-of-court settlement are subject to revocation in the event of a future failure of the company. In the event of bankruptcy, civil and criminal liability could be ascertained on the part of both the directors and the Supervisory Board, for non-compliance of equal treatment of creditors. The Supervisory Board must therefore pay the utmost caution before giving consent to such assignment. It should at least ensure that the payments take place in accordance with the order of first refusal if the same happens in more installments or that all creditors are consenting to the agreement in the case of simultaneous payment.

In the event that the Shareholders Meeting decides for an agreement and precisely like the Rule no. 11 provides, the Recovery and Resolution Plan in accordance with subparagraph d) of the third paragraph of Article 67 L.F., the Supervisory Board will monitor the setting and the evolution of the procedure. The Recovery and Resolution Plan puts the creditors under the condition to adhere more easily to the proposals of the debtor assuring that the various operations specified by the law remain valid without the possibility, in the event of bankruptcy, to be revoked. It is not, however, recognized the pre-deductibility of credit and so, in a subsequent bankruptcy proceedings, the credit accrued will be privileged only if they are assisted by guarantees. The agreement being governed by law that doesn't have criminal implication for the Supervisory Board so its function in this case will be easier and less burdened with worries though, as in the out- of-court settlement, it is good that precautions are taken to avoid any possible civil liability. The Supervisory Board must control the preparation of the plan, then subject to an examination by the Court, that should appear as specifically established by the norm, suitable to allow the recovery of the debts of the company and to ensure the balance of the financial situation. The Supervisory Board is not required to declare that the plan, as prepared by the debtor, is "reasonably" appropriate to achieve the purposes prescribed because such proof is left to the Independent Expert, the professional appointed for this purpose, but it is certain that it cannot escape from the recognition that the plan is able to achieve consolidation of debts and achieve financial balance. The Supervisory Board shall therefore examine both law enforcement and compliance with the obligations of behavioral correctness the substantive control, if with the unilateral proposal prepared by the debtor it will be able to achieve the purpose of preserving the continuity of the enterprise and its survival and also the reliability of the accounting data for used in preparing the plan. Practically to the Supervisory Board is requested to express its opinion if by way of remission or reduction of the outstanding debt or by revising the payments, as proposed by the debtor, the company will be able to achieve the restoration of financial stability. The Rule no.11 doesn't provide who should appoint Independent Expert, but establishes that the same should be recorded in the register of auditors, with the requirements referred to the art. 2501-bis, paragraph 4 of the Civil Code.

ii. Conduct rule no. 11.4- Role in Restructuring Agreements (art. 182-bis l.f.) The Restructuring Agreement provided by the art. 182-bis of the L.F, represents a real bankruptcy proceedings. The Rule No. 11.4 governs the monitoring actions of the Supervisory Board during the Restructuring Agreements. In particular the Supervisory Board should look after all formal requirements necessary for the approval by the Court and the execution of the plan with particular attention to the payment of external creditors. Even for the debt restructuring agreements the task of the Supervisory Board will be to evaluate the plan, to monitor the implementation period, paying attention to situation leading to changes of the planned actions. Great care must be given specially to the evaluation and monitoring of financial flows foreseen in the plan.

iii. Conduct rule no. 11.5- Role in Pre-insolvency Agreements (art. 160 l. f.) () Pre-insolvency Agreements with creditors are the more common way to compose a state of crisis or insolvency. With the recent bankruptcy reform a more private character - rather than the previously existing public one - has been recognized to Pre-insolvency Agreements. A major relevance to the decision of the creditors has been introduced. Creditors, and not the Court, have the right to choose between the pre-insolvency agreements and bankruptcy declaration. In case of Pre-insolvency Agreements the Supervisory Board will primarily carefully examine the causes that have produced the crisis or insolvency and then will

express its opinion about the choice. The Supervisory Board shall cooperate with the entrepreneur for the fulfillment of all the formal requirements provided by law, including the assumption of the prior deliberation to be carried out in accordance to the art. 152 lf. It should be noted that during the procedure the company's assets are left available to the borrower and that the Supervisory Board, in all its possibility, has to make sure that subtractions or loss of assets doesn't occur. Likewise, it should be noted that, during the procedure, regular accounting must be kept by the company so that the Supervisory Board must exert periodic inspections and prepare the report to the financial statements. This task has to be done even after the closing of the procedure, even if the approval phase is followed by the liquidation of the assets and not by a going concern situation.

3.2 Auditor

In bigger companies figures are controlled by an Auditor (an Audit Firm or a Registered Auditor). When this happens duties are no more all on the shoulders of the Supervisory Board, as it happens in smaller entities, but they get split between the Auditor and the Supervisory Board.

Both Auditor and Supervisory Board, carry out relevant controls activities that should be able to help identifying early symptoms of the crisis.

Members of the Supervisory Board are, as already pointed out, entrusted with supervising the areas: compliance with the law and the by-laws of the company; correct administration and internal controls; adequacy and reliability of the organizational and administrative structure; adequacy and reliability of the accounting system. The members of the Supervisory Board report to the Board of Directors their considerations on the company situation leading them to think about the consequences of decisions to be taken on the going concern of the firm. This takes place directly during Board of Directors meetings meanwhile decisions are taking.

The Auditors - instead - are called to monitor and measure the impact of decisions on balance-sheet items and results, but audit, of course, takes place after decisions have been taken. The ordinary audit activity in crisis contexts indeed includes, exactly as in ordinary contexts, preparing quarterly and annual audit expressing on these bases the opinion on the financial statements. Procedures and principles that are implemented by the Auditor do not change even if it is necessary more attention and investigation to identify risks and to evaluate critical items.

What characterize the Italian context is the common co-existence in companies of the continuous ex ante - on decisions - and ex post controls - on figures generated by decisions - which should build up, when fitting and well implemented, a strong corporate governance structure. The recalling and the warnings of both bodies represent essential tools that should help the Board of Directors to realize the coming of the crisis from the first signs and to be consequently able to identify on time a structured strategy to overcome it.

The model certainly requires professional involved to prove a great level of competence, but professionalism is not enough particularly in special contexts. Cooperation with full transparency and consistent information exchange between the two governance bodies is needed. If the cooperative approach is relevant in growth or steady situation, it becomes a key factor when the crisis begins to arise. Italian law - with art. 2409 septies c.c. - and auditing standards require it and specify that a useful collaboration is not only a matter of fair professional behavior, but must be considered a compulsory and necessary procedure and must be mutual and prompt.

3.3 Independent Expert (Attestatore)

Reformed bankruptcy law recognizes a key role of the Independent Expert who is asked to render an opinion on the feasibility of the plan. The Expert must be a registered auditor. This introduces a relevant novelty in the Italian tradition. The company must appoint an Independent Expert, named *Attestatore,* who will examine the proposed agreement, audit the financial data on which the plan is built and examine, in accordance with recognized assurance standards, the plans the company declares it is able to implement. The Independent Expert *(attestatore)* must be appointed by all companies that approach one of the three procedures introduced in the Italian context. In the context of hybrid procedures (Art. 182bis) and of formal reorganizations (Art. 160, Art.186bis) the report of the independent auditor *(attestatore)* is the first document, together with the debtor application, from which the court learns about the agreement. He is not an advisor, as his role is to safeguard creditors' interests. His point of view correspond to the Court and the Creditors' one, as his findings and conclusions will be the main information on which the Court will take its decision to open the procedure. The reform of September 2012 provided a requirement for strict independence, including a long cooling-off period. To be considered independent, the Expert and his partners cannot have been advisors of the company or part of the management or supervisory board or Supervisory Board *(collegio sindacale)* in the last five years; and relevant criminal sanctions in case of unfair and untrue disclosure: if the independent auditor exposes false information or otherwise does not report important information, is punished with detention or important penalties. If the events are committed in order to achieve an advantage for himself or for others and if from the act is achieved an offense to creditors sanctions may be increased.

The feature of total non-involvement in company matters puts the Independent Expert (Attestatore) in a position characterized by information asymmetry

towards the company. This makes crucial the relationship with company's controllers - Supervisory Board and Auditor - who have knowledge of the company situation and that, for first, have - or at least should have - monitored the crisis signs and the failing of going concern. Once more cooperation with full transparency and consistent information exchange becomes a critical factor. The Independent Expert (Attestatore) needs to confront with the two pre-existing governance bodies even if its position must remain separated and free-standing. Their dialogue must start in fact from the consideration of their respective roles and responsibilities.

In this perspective, the audit carried out on the annual reports by the Auditor, seems to represent a logical starting point for the Independent Expert (Attestatore) audit of financial data the plan is built on. However, unfortunately, Auditors - in particular Audit Firms - are not likely to agree with this point of view. The Italian Auditors Association (Assirevi) is in these days outlining a document draft in which it is claimed:

• that the aims of the Auditor annual opinion and the aims of the Independent Expert due diligence on the figures which represent the starting point of the plan to get out from a crisis period are different;

• that consequently, even if the Independent Expert and the Auditor happen to audit the same figures for the same company for the same period, they should follow separated patches;

• that audit evidence collected and the Audit Documentation by the Auditor shouldn't be made available for the Independent Expert.

This statements do not promote the idea of building up good flow of information among the independent experts involved in the process and introduce, as pointed out by the data here examined, a fence difficult to overcome.

3.4 Court and Trustee

In Pre-insolvency Agreements *(concordato preventivo ex Art. 160 lf and 186bis lf)* the Court verifies compliance between the law previsions and the debtor's formal reorganization (or liquidation) plan together with the Independent Expert's opinion on the feasibility of the plan and on the fairness of the figures on which the plan was built. If the results are adequate, the Court opens the procedure and appoints a Trustee to look after the debtor activity[2]. He supervises his behavior while the debtor goes on managing the company during all the reorganization period, he checks the list of creditors and debtors provided by the company and draw up an inventory of the assets. The Trustee communicates to creditors his opinion about the proposed Pre-insolvency Agreement in a special public report. This document is made available to the creditors some times before the day they are called to vote so that they can take an informed decision. He chairs the creditor's meeting during which creditors are called to express their vote on the proposed agreement.

Some of the contents of the Trustee report are similar to the one of the Independent Expert as both audit the company's figures and give an opinion on the feasibility of the plan. From a technical point of view the Trustee should verify the activities carried out by the Independent Expert. He can choose to repeat all of them or - if he considers the Independent Expert job enough structured and reliable - he can choose to only analyze a sample them in order to validate them.

The Trustee goes then on with his analysis going through a fraud audit procedure and comparing the proposed scenario with the alternative bankruptcy scenario. This means that he has to try to imagine and describe a picture of this second situation. The Trustee necessarily has, hence, to include in his report considerations about the likelihood to successfully implement different legal actions and an estimation on one side of the controversy value and on the side of the time necessary to get the goals considered. Litigations can be drowned for instance against, managers, Auditor and statutory auditors if the Trustee considers them to have some responsibilities having had a role in the worsening of the situation.

It is important to highlight that the point of view the Trustee has to share is the creditors' one, as his findings and conclusions will be the main information and elements on which creditors will take their vote decision. Being appointed by the Court the position from which the Trustee operates is stronger than the one from which has operated the Independent Expert at the beginning of the procedure. Even if this last has perfectly behaved, roles are different. The Independent Expert faces his difficult due diligence equipped by his professionalism, competence and moral strength. The Trustee has additional and delicate duties, but he is also given, thanks to his functionary status, the power necessary to go through them.

It is possible to affirm that the Independent Expert, the Trustee and the Court are all interested in reaching the same goal, which is to inform creditors about the debtor's offer in a reliable way. The sustainability of the hypothesis on which the plan is based is somehow "guaranteed" by their auditing, assurance and investigation. It is up to creditors whether or not to accept the agreement.

As all of them are working to protect the same interests it should be expected them to cooperate or at least to exchange information and documents.

[2] As already pointed out, this does not happen in Recovery and Resolution Plans (piano attestato ex art. 67 lf) which are Out of Court procedures, while in Restructuring Agreement (accordo di ristrutturazione ex art. 182 bis) the Court verifies compliance but does not appoint a Trustee.

4 First results of the research

In June 2012 a group of Italian researchers from different Universities together with the President of the Bankruptcy Judges of Milan Court started an important research aiming at analyzing *Art 160 lf* procedures[3]. The aim is to understand the trends developed in Lombardy major Court from 2007, that is supposed to be representative of the first applications, to nowadays. It is important to say that Milano Court is - together with Rome - the most relevant Italian Court. Each *Art 160 lf* dossier have been analyzed cover to cover. As shown in Figure 3, up to now all 2011 and almost all of the 2012 dossiers have been processed. This means that we 284 dossier representing the all population of procedures presented in Milano Court in the period considered have been analyzed. Some of the first research processing and results are presented in the following pages using a simple approach as a descriptive analysis.

Data shows that not all applications were admitted: 32% were refused by the Court as the documents of the application were considered noncompliant with the formal standard. Much more interesting is the final results of the admitted procedures admitted. Only 26% of the them have been successful. This is a surprising result and suggests that much has to be done by professionals to build adequate agreements and by standard boards and academia to help professionals and companies reaching their goals.

The focus is here on the Controllers behavior observed in the selected situations and particularly on the flows of information among Corporate Controllers and the Independent Expert involved in the first part of the process. As already pointed out being able to walk through the documentation of the Corporate Controllers and to have access to the evidence already collected and analyzed by them can be of great help for the Independent Expert exam of the fairness of the figures. More important this can reduce the timing of his audit work which is usually expected to take a long period as, if not supported, he can't avoid to implement all audit procedures from the top. The analysis does not consider the flows of information among on one side the three mentioned Controllers appointed by the Companies and on the other side the Trustee and the Court. The choice is linked to the strongest empowerment of the last two roles and to the consequent duty for the first to exchange information and giving access to any documentation with the second.

First of all the research confirms that the corporate governance model preferred by Italian companies is what we have called in the first pages the "Traditional Italian Model" where the Supervisory Board is up and running. In fact in about 87% of the dossier considered the analysis of the official historical data of the companies included in the sample has pointed out the presence of the board of directors together with the Statutory Auditors Board. The relevance of this result is highlighted by the fact that only 1% results having implemented the monistic model and it seem totally not implemented the dualist one. In addition as no information were found in 12% of the dossier it cannot be excluded that some more companies effectively adopt the traditional model.

In almost 60% of the cases implementing the Traditional Italian model, the Statutory Auditors Board not only watch out for Board activities but also audits the annual report. This means that in most cases the Statutory Auditors Board is responsible for both: i) on one hand for supervising the compliance to the law, the observance of correct administration principles, the organizational structure adequacy, the presence of a fitting control system; ii) on the other hand for controlling the accounts implementing all the auditing procedures necessary for the release of the opinion on the annual report. In the remaining cases an Auditor is selected to look after the second class of activity, that is the auditing one.

The research points out that communication flows among the Supervisory Board, the Auditor - if existing - and the Controller selected by the company to be able to implement the procedure, that is the Independent Expert, seems to be too weak.

Only in 30% of the Independent Expert Opinions it is possible to find out that there have been an exchange of information between the Independent Expert and the Supervisory Board. The percentage falls to 19% if the Auditor is considered consistently with to the approach suggested by the Auditors firm Association. In all other dossier no news about contacts among controllers have been found meaning that either effectively there have been no connection among controllers or that any relevance has been given to information received from pre-existing controllers by the Independent Expert. At this level the setting of the query was general to be able to consider all the possible evidence of the structuring of a contact.

[3] The research has been implemented by: Riva P. (Università del Piemonte Orientale, SAF Scuola di Alta Formazione Dottori Commercialisti Milano), Danovi A. (OCRI Università Bocconi, Università di Bergamo), Bianco C. (SAF Scuola di Alta Formazione Dottori Commercialisti Milano) together with La Manna F. (President of the Bakruptcy Judges of Milano Court), Fontana R. (Bankruptcy Judge of Milano Court). The research is not sponsored and has beeb implemented on voluntary basis.

Figure 3. The Sample – Pre-Insolvency agreement Dossier analyzed

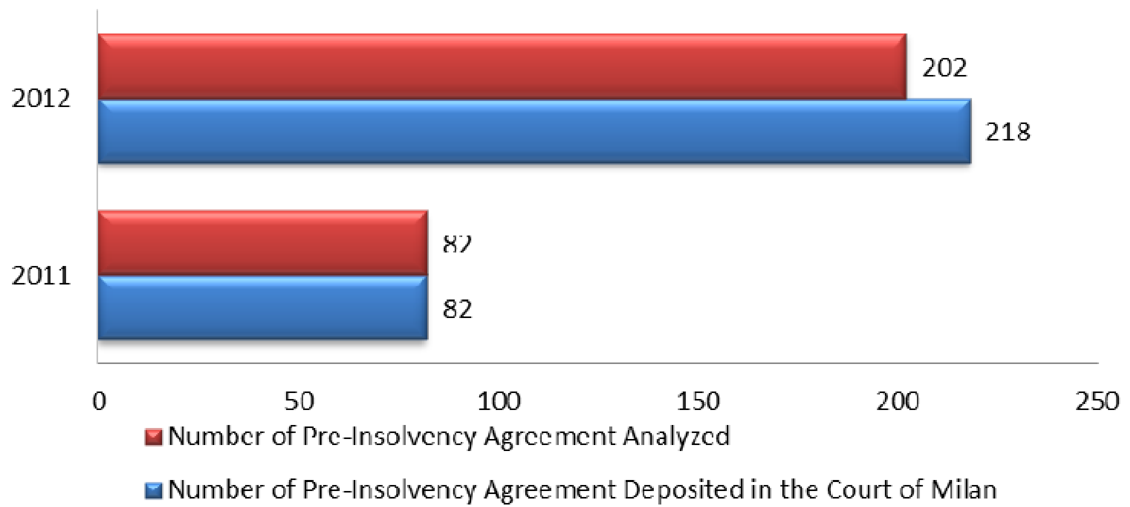


Figure 4. Corporate Governance of companies included in the sample

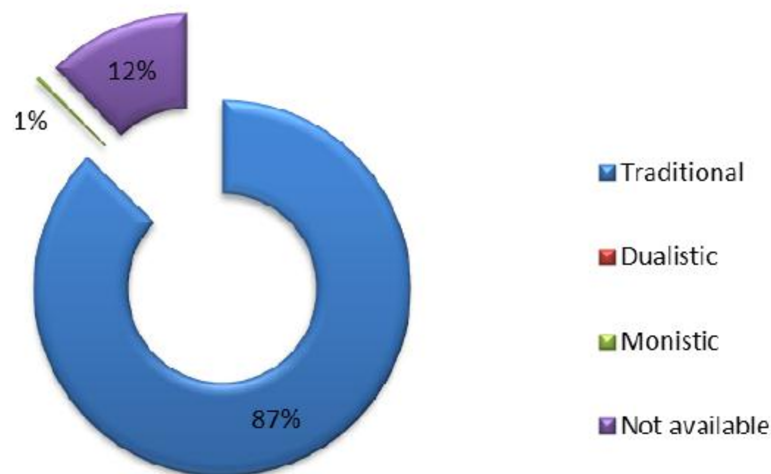


Figure 5. Exchange of information between the Independent Expert and the Supervisory Board

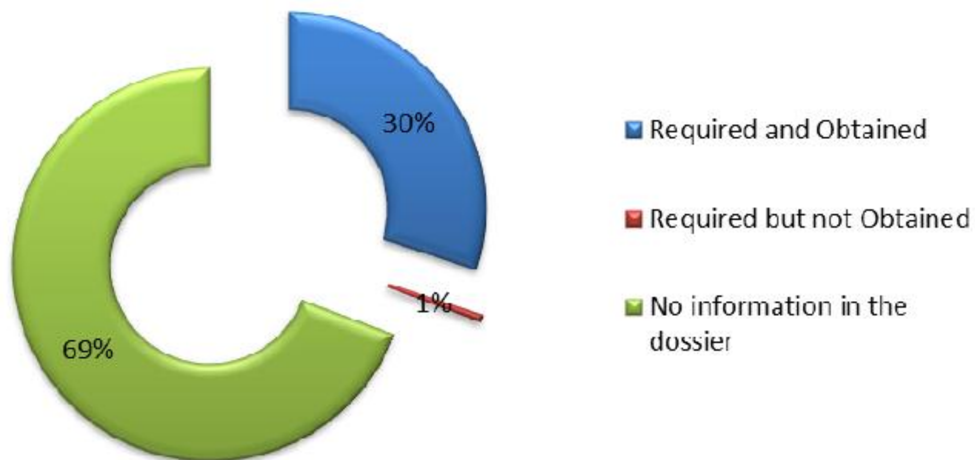
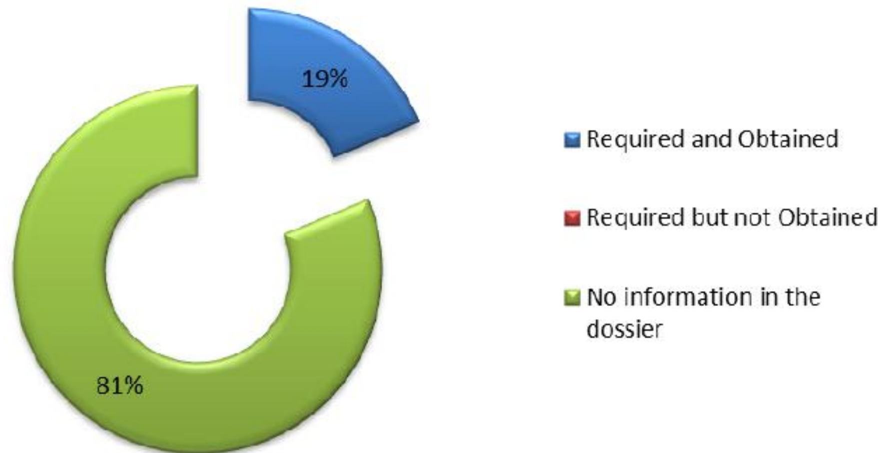


Figure 6. Exchange of information between the Independent Expert and the Auditor if existing



To understand the nature of the flow of information registered, more attention has been hence given to the content of the opinion produced by the Independent Expert. The exchange of information in fact could consist in "simple conversation" about the business, the crisis situation and the strategy planned to solve it, or it could go over this asking the Corporate Controllers to produce their Documentation. The analysis gives an interesting result as the behavior of on one hand the Supervisory Board and on the other hand the Auditor seem again to be different.

Only in the 14% of dossier analyzed results that the Supervisory Board has given access to its documentation. This means that in more than 50% of the situation where the Independent Expert has declared to have had a positive contact with the Supervisory Board - 30% of dossier, see Figure 5 - he has obtained only "simple conversation", but not sharing of evidence. This can be explained by structural reasons as in almost all these cases the Statutory Auditor Board is not involved in the audit of the figures which is delegated to the Audit Firm.

In 17% of dossier analyzed results that the Auditor has given access to its documentation, in 1% of dossier the Auditor has denied the access and the Independent Expert has reported in his opinion about this behavior. This means that in almost all situation where the Independent Expert has declared to have had a positive contact with the Auditor - 19% of dossier, see Figure 6 - he has obtained the sharing of audit evidence. In other terms when Auditor decides to disclose they seem to move in full transparency.

Anyway both outcome turn out to be significant of a gap between what is needed and what effectively takes place.

Figure 7. Independent Expert Using the Work of the Supervisory Board

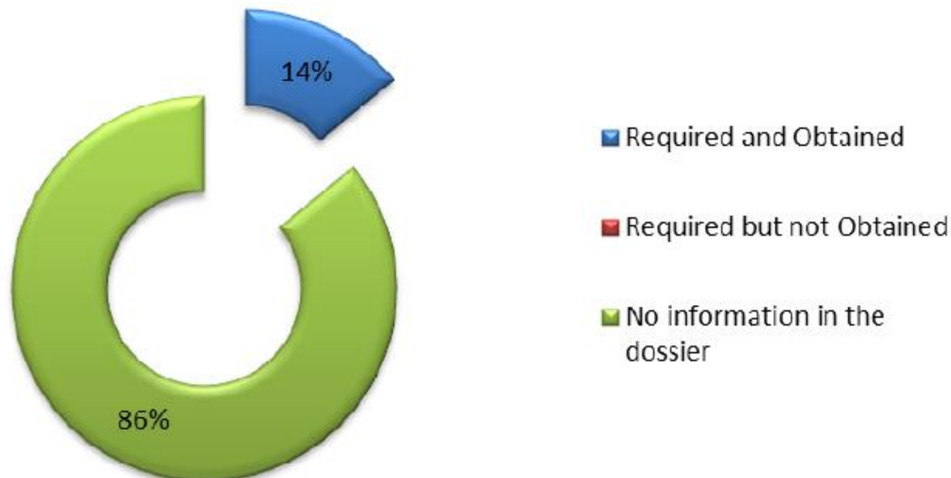
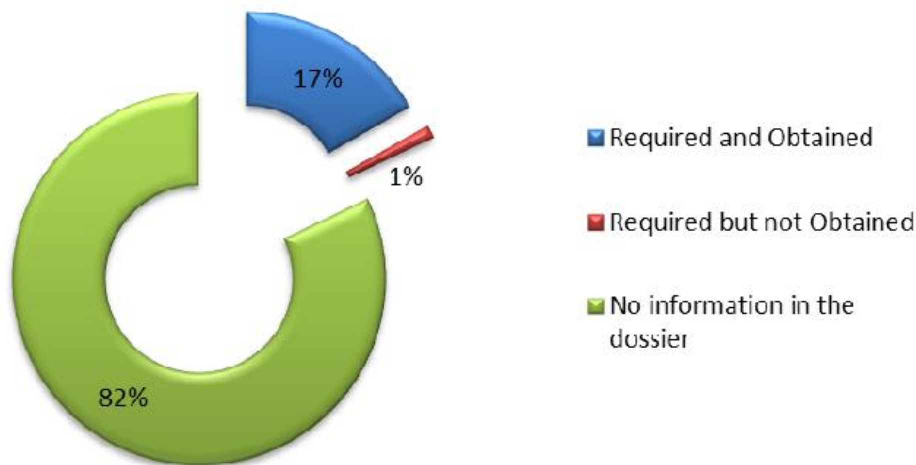


Figure 8. Independent Expert Using the Work of the Auditor



5 Conclusions and future objectives

The introduction in the Italian context of tools to help companies face difficulties in crisis periods has represented a "cultural revolution" for the Italian context. Formerly, the main aim of Italian bankruptcy and business recovery used to be the protection of creditors, while now the goal is claiming priority to safeguard companies and reduce their difficulties (Riva P., Provasi R., forthcoming). In spite of this, data from the empirical analysis show that first application results, referred to a sample of Pre-insolvency Agreements are not satisfactory as the number of successful procedure is not adequate. Much has to be done by professionals to build adequate agreements and by standard boards and academia to help professionals and companies reaching their goals. All Actors involved in the process with a Control role need to behave rigorously to be able to test the quality of the operations planned. Different roles and different duties are defined by the recently reformed bankruptcy law. Each professional involved is committed to face his own responsibilities.

The analysis that this demand for serious engagement seems to have been frequently interpreted as a reason to ban professional exchanging of information and sharing of relevant documents among different Controllers. This happens especially in the first delicate period when time is a precious resource as the strategy is being defined and the application is being composed. Only in a minor percentage of the procedures analyzed the Independent Expert has found support and has had access to the work of the Supervisory Board and of the Auditor.

Results seem hence to show a possible path useful to improve efficiency, but also efficacy, in managing successfully the Restructuring Techniques newly introduced in the Italian model.

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RECHARACTERIZATION OF DEBT TO EQUITY UNDER U.S. LAW AND ITS EFFECTS ON CORPORATE GOVERNANCE

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Abstract

This Essay examines the practice of recharacterization under U.S. law and focuses, in particular, on the standard of review applied by bankruptcy courts in order to determine whether a purported debt transaction should be considered as an equity contribution and on the effect of such a recharacterization of debt to equity on corporate governance. In doing so, Paragraph 2 provides a brief overview of the concept of recharacterization in general. Paragraphs 3 to 6 describe some of the most commonly accepted factors taken into account by bankruptcy courts and try to identify two main approaches that may be taken in weighting these factors. Finally, Paragraph 7 identifies some of the policy reasons underlying the concept of recharacterization and explores whether this practice has an impact on corporate governance****.

Keywords: Debt; Equity; Corporate Governance

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*****A preliminary version of this Essay has been presented by the Authors at the International Conference "Corporate Governance and Regulation: Outlining New Horizons for Theory and Practice" held in Pisa, Italy, on September 19, 2012. Even if jointly elaborated, this Essay has been drafted as follows: paragraphs 4 and 5 by Andrea Dardano; paragraphs 2 and 3 by Andrea Sacco Ginevri; paragraphs 6 and 7 by Ferruccio Maria Sbarbaro.*

1 Recharacterization of claims in general

Recharacterization consists in the authority of bankruptcy courts to rule that a claim against the trustee, or debtor in possession, should not be considered as an actual debt claim but rather as an equity interest[4]. The result of such a ruling is that the recharacterized claim is subordinated to *all* the debt claims of (other) creditors and is treated *pari passu* with the claims of the equity holders.

Recharacterization is often considered a confusing device, probably because it shows some similarities with another instrument used by bankruptcy courts, namely the "equitable subordination". Quite surprisingly, even some bankruptcy courts have shown a certain degree of uncertainty in determining whether certain claims had to be recharacterized or equitably subordinated, with the result that some courts have recharacterized claims that other would equitably subordinate[5]. However, once the proper role of recharacterization has been understood, the distinct purpose of equitable subordination and recharacterization becomes clear and confusion can easily be avoided[6].

In a nutshell, recharacterization and equitable subordination come into play at different stages and serve different purposes. The former is used to determine whether a purported debt claim actually exists (or should rather be considered as an equity interest), while the latter is used to subordinate an actually existing debt claim to those of other creditors, because of some inequitable conduct engaged into by the subordinated creditor, and only to the extent necessary to remedy to the inequitable conduct[7]. Thus,

[4] It is worth noting that a minority of the bankruptcy courts does not recognize the authority to provide such a relief. See e.g., In re Outboard Marine Corp., 50 Collier Bankr. Cas. 2d (MB) 931, 2003 WL 21697357 (N.D. Ill. 2003); In re AutoStyle Plastics, Inc., 269 F.3d 726, 748, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001) (citing In re Cold Harbor Associates, L.P., 204 B.R. 904, 915, 30 Bankr. Ct. Dec. (CRR) 336, 37 Collier Bankr. Cas. 2d (MB) 753 (Bankr. E.D. Va. 1997), all cited in 2004 Annual Survey of Bankruptcy Law, Sprayregen, Friedland, Brighton, Bianca, Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine, footnote 3.

[5] M. NOZEMACK, Note, Making Sense Out of Bankruptcy Court's Recharacterization of Claims Why Not Use Section 510(c) Equitable Subordination? 56 Wash. & Lee L. Rev. 689, 716 (1999). See also In re AutoStyle Plastics, Inc., 269 F.3d 726, 748, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001).

[6] 2004 Annual Survey of Bankruptcy Law, cit., p. 3.

[7] In re AutoStyle Plastics, Inc., 269 F.3d 726, 747, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir.

when (and only if) a claim is recognized as being an existing debt claim, equitable subordination may be considered. In other words, if a claim is recharacterized, equitable subordination never comes into play[8]. An important difference between recharacterization and equitable subordination is that the former, unlike the latter, does not require any finding of inequitable conduct on behalf of the "lender". Therefore, recharacterization exclusively involves the determination by a court that a transaction that the parties have characterized as debt should be actually treated as an equity contribution [9].

It is important to note that the 3rd U.S. Circuit Court of Appeals, in the opinion of *In re Submicron Systems Corporation*[10] citing a dicta of the U.S. Supreme Court in *Pepper v. Litton*, held that the bankruptcy court's ability to recharacterize purported debt as equity, just like its ability to equitably subordinate debt, is grounded in its equitable authority "*to ensure that substance does not give way to form and that technical considerations do not prevent substantial justice from being done*"[11]. The interplay between substance and form in the context of recharacterization will be discussed again in Paragraphs 4 and 5 of this Essay.

2 The multi-factor tests

The major difficulty in determining a clear standard for recharacterization is probably due to the fact that courts employ many different standards of review, without clear indications about what elements – or group of elements – should have prominent relevance. On the contrary, courts say that all the factors taken into account must be weighted as a unique group, so that none of them should be decisive. Recharacterization requires a fact intensive analysis and courts usually prefer to have a case-by-case approach, rather than developing a rigid doctrine to be applied to all cases. Even if such a flexible approach seems appropriate in the context of recharacterization, its inevitable result is uncertainty: insiders willing to provide cash to a struggling corporation are left without clear indications as to whether their advance will be characterized as equity or debt.

In *AutoStyle Plastic* the court applied an 11-factor test derived from a tax case, *Roth Steel Tube*, in which the issue was recharacterization of tax claims[12]. These are the most commonly accepted factors used by courts to evaluate whether a claim should be recharacterized. In listing these factors this Essay will not follow the order used by the *AutoStyle Plastic* court because, for the purposes hereof, it seems more useful to divide such factors in three categories, on the basis of the different elements on which each category focuses, namely: (I) the formalities of the alleged loan agreement; (II) the financial situation of the company and how the parties actually treated the advance, and (III) the relationship between the creditor and the debtor[13].

The first group includes those elements that may be referred to as the "formal factors"; their purpose is to evaluate whether the transaction respects the formalities of proper debt transaction. Factors in this group are: (i) the name given by the parties to the instruments, if any, evidencing indebtedness; (ii) the presence of a fixed maturity date and schedule of payments; (iii) the presence of an interest rate and interest payment; (iv) the security, if any, provided by the borrower; (v) the extent to which the claims were subordinated to those of outside creditors; and (vi) the presence of a sinking fund to provide repayments.

The second group includes: (aa) adequacy of the capitalization of the company; (bb) the sources used for the repayments; (cc) the extent to which advances were used to acquire capital assets; and (dd) the corporation ability to obtain outside financing.

The third group is composed by a sole factor among those elaborated in *AutoStyle Plastic*, namely the identity of interest between the creditor and stockholder. In addition to this, however, the court of *In re Outboard Marine Corporation* elaborated two factors that can be properly included in the third group: (x) the ratio of shareholder loans to capital; and (y) the amount or degree of shareholder control[14].

For the purposes of this Essay, the factors falling into groups two and three shall be collectively referred to as the "substantial factors".

3 The role of the formal factors

With regard to the formal factors one could wonder: why should courts use them in determining whether a

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2001). See also 2004 Annual Survey of Bankruptcy Law, cit., footnote 11 and accompanying text.

[8] LLBL 6.03A, 2010 WL 3878862; In re Georgetown Bldg. Associates, Ltd. Partnership, 240 B.R. 124, 137, 35 Bankr. Ct. Dec. (CRR) 95, 42 Collier Bankr. Cas. 2d (MB) 1946, 42 U.C.C. Rep. Serv. 2d 1050 (Bankr. D. D.C. 1999). See also 2004 Annual Survey of Bankruptcy Law, cit., footnote 12 and accompanying text.

[9] See 2004 Annual Survey of Bankruptcy Law, cit., footnote 59 and accompanying text.

[10] 432 F.3d 448, 455-56 (3d Cir. 2006).

[11] 308 U.S. 295, 305, 60 S.Ct. 238, 84 L.Ed. 281 (1939), emphasis added.

[12] Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986).

[13] These categories are a re-elaboration of those described by M. NOZEMACK, Note, cit., 709.

[14] These factors have been elaborated by the court of In re Outboard Marine Corp., 50 Collier Bankr. Cas. 2d (MB) 931, 2003 WL 21697357 (N.D. Ill. 2003) and derived from In re Hyperion Enterprises, Inc., 158 B.R. 555, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993).

claim is debt or equity? In other words, what function do these factors serve? If we move from a presumption that the parties acted in good faith, the formal factors may be seen as a tool used in order to determine the actual intent of the parties with respect to their agreement. One could argue that, if the parties called the relevant instruments with names evidencing a debt transaction, provided for collaterals to secure the repayments and so on, they actually wanted to conclude a debt transaction and, therefore, the court should not recharacterize it as debt.

However, a more pragmatic approach suggests that the formal factors have very little effectiveness, if any, in discovering the actual intent of the parties. To the contrary, if courts relied too much on them, it would become relatively easy for sophisticated parties to obviate the court's scrutiny. This could be done by simply executing a "loan" agreement which provides for: (i) a fixed (but illusory) maturity date; (ii) a fixed interest rate (payment for which can be deferred until the maturity date); and (iii) the granting of securities for the advance. The unsecured creditors would then be left with the difficult task of uncovering a "smoking gun" that demonstrates that the true intent of the parties was different[15]. The inevitable result would be that recharacterization claims would almost always be rejected, if ever brought to courts.

An example of a situation of this kind can be found in *AutoStyle Plastic*, precisely in the part of the opinion where the court analyzes the presence of a fixed interest rate and interest payments[16]. The court says that the agreement provided *ab initio* for both an interest rate and interest payments. The parties subsequently agreed to defer interest payments. However, according to the court, this factor is not indicative of equity but, at best, it cuts both ways, since the deferral of interest payment indicates the possibility that during the course of the transaction the defendants eventually never expected to get repaid and converted their debt to equity. Still, it does not change the fact that, initially at least, there was a fixed rate and interest payments, "*indicating that the transaction was originally intended to be debt, not equity*"[17]. Thus, according to the court, (a) the original intent of the parties may be inferred by an analysis of the formal factors and, (b) even if the parties eventually acted inconsistently with the intentions stated in the transaction documents, this simply means that they changed their mind during the course of the transaction. However, the court, relying on *In re Cold Harbor*, stated that such change in the intent of the parties should not be taken into account because "*recharacterization applies to transactions that were equity contributions ab initio*"[18].

Conversely, the court of *Submicron System* held that the determinative inquiry in classifying advances as debt or equity is the intent of the parties "*as it existed at the time of the transaction*"[19]. In this case, the court (which included now Supreme Court Justice Alito) refused to apply a multi-factor tests and, rather, focused more generally on the intent of the parties. The court stated that the multi-factor tests undoubtedly include pertinent factors, but they devolve to an overreaching inquiry: the characterization as debt or equity is a court's attempt to discern whether the parties "*called an instrument one thing* when in fact *they intended it as something else*". Then the court goes on saying that the intent of the parties may be inferred, among other things, also "*from what they say in their contracts*"[20]. However, thereafter the court adds that "*form is no doubt a factor, but in the end it is no more than an indicator of what the parties actually intended and acted on*". In the same page of the opinion, the court also recognizes that no mechanistic scorecard suffices and that answers lie in facts that confer context case-by-case. It is worth to underline that the other two elements mentioned by the court as indicators of the parties' intent are: (i) what the parties do through their actions and (ii) the economic reality of the surrounding circumstances, which indeed appear to be more powerful tools than a mere review of the formalities set up by the parties. Interestingly, as will be discussed below, these two elements may actually be included among the substantial factors according to the classification described above in this Essay[21].

An increased focus on the substantial elements of the transaction is clearly shown by the Courts of Appeal for the Eleventh and Fifth Circuits in some tax cases[22]. In these cases, the courts employed a 13-factor test, very similar to the *AutoStyle Plastic* test, with the significant difference that they mentioned the "intent of the parties" as a distinct and additional factor with respect to the formal ones. In particular, in *Estate of Mixton* the court draws a distinction between the *subjective* and *objective* intent of the parties[23]. According to the court, the parties' intent to create either a debt or equity relationship is the ultimate issue to be determined. However, the court goes on, notwithstanding their *subjective* belief, the parties may *objectively* manifest their intent through their actions,

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[15] M. KLEIN, R. R. SUSSMAN, Recharacterization Battles Likely in Next Round of Bankruptcies, Turnaround Management Association, 5.

[16] AutoStyle Plastics, Inc., 269 F.3d 726, 751.

[17] Ibid., emphasis added.

[18] Ibid.

[19] 432 F.3d 448, 457 (3rd Cir. 2006).

[20] In re Submicron System Corporation, 432 F.3d 448, 456 (3rd Cir. 2006).

[21] See pages 3-4 above.

[22] Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638 (11th Cir.1984) (citing Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir.1972)) both cited in Submicron System.

[23] Estate of Mixon v. United States, cit., 407.

also taking into account the economic reality in which they acted. Therefore, the crucial point of this issue is understanding whether the *subjective* intent of the parties, as expressed in the corporate documentation, should be disregarded in characterizing the transaction. The answer of the court to this question is that there is a well-recognized principle in all areas of the law: that a *subjective* intent on the part of an actor will not alter the relationship or duties created by an otherwise *objectively* indicated intent. This approach clearly recalls a *substantial* way of thinking of recharacterization, indicating that the substantial factors should have prominent importance in order to infer the (objective) intent of the parties[24]. In other words, the actual behavior of the parties, in connection with the economic reality in which they acted, can say more about their intent than the facial appearance of the transaction. This is what the court implies when, citing *Tyler v. Tomlinson*[25], it says that law requires that creditorship have genuine existentiality and that "*this requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature captions*"[26].

In the same line of reasoning, in *Stinnett's Pontiac* the court, recalling somehow the wording of the Supreme Court in *Pepper v. Litton*, says that to hold that the *subjective* intent of the parties should prevail over their *objective* intent would be to ignore the plain facts and to elevate form over substance[27].

Thus, if – as suggested above – the formal factors should not be considered in order to determine the intent of the parties, what is their proper role in the context of recharacterization? Should courts continue to take into account these elements?

A possible answer to these questions might be that, due to the scarce effectiveness these factors have in understanding the real nature of a transaction, courts should give them a more limited consideration. In particular, the suggestion is that these factors should be treated as "negative" factors, meaning that their *presence* should be generally seen as a (very weak) indication of a debt transaction, but only if the analysis of the substantive aspects of the transaction points to the same conclusion; conversely, their *absence* should be seen – of course always in the light of the other factors – as a strong indication of an equity contribution, especially (or maybe even exclusively) in the context of a transaction between *sophisticated parties*, which would very unlikely enter into a real debt transaction without the proper transaction documentation and adequate guarantees in place. This seems particularly evident, for example, if we think about elements such as: (i) the name given by the parties to the instruments, if any, evidencing indebtedness; (ii) the presence of a fixed maturity date and schedule of payments; (iii) the presence of an interest rate and interest payment; (iv) the security provided by the borrower; or (v) the presence/absence of a sinking fund.

4 The role of the substantial factors

As discussed above, the other groups of factors elaborated in *AutoStyle Plastic* and in *Outboard Marine* include the following elements:

- the financial situation of the company and how the parties actually treated the advance, including:
  a. the adequacy or inadequacy of capitalization;
  b. the sources used for the repayments;
  c. the extent to which advances were used to acquire capital assets;
  d. the corporation ability to obtain outside financing; and
- the relationship between the creditor and the debtor, including:
  e. identity of interest between the creditor and stockholder;
  f. the ratio of shareholder loans to capital; and
  g. the amount or degree of shareholder control.

Instead of describing individually each of the substantial factors, this Essay will analyze them as a unique group, in the light of the collective role(s) they can assume in a recharacterization analysis.

As discussed in Paragraph 3, above, the substantial factors can be used by courts for determining the real intent of the parties in connection with a given transaction. Some courts, following the approach indicated by *Submicron System*, are starting to refuse the application of a multi-factor test, while privileging a case-by-case approach that can lead to a *common sense* evaluation of the facts and circumstances surrounding a transaction[28]. However, as we have already seen, such *common sense* approach will not differ too much, and probably cannot prescind from, an analysis of at least some of the substantial factors, in particular (i) what the parties do through their actions and (ii) the economic reality of the surrounding circumstances[29].

In this context, certain substantial factors may assume a particular relevance. For example, in order to be able to characterize a claim as an equity interest, it is necessary to find an identity of interest between the creditor and the stockholder: it would be unreasonable to think that an external lender, simply

[24] This issue will be discussed in further detail below. Furthermore, as will be discussed 2 below, this Essay suggests that some of the substantial elements should also be taken into account in determining the level of dangerousness of the transaction with respect to the rights of outside bona fide creditors.

[25] Tyler v. Tomlinson, 414 F.2d at 850.

[26] Estate of Mixon v. United States, cit., 407.

[27] Stinnett's Pontiac, cit., at 639 (citing Tyler v. Tomlinson, cit., at 850).

[28] Radnor, 353 B.R. 820, 838; 2006 Bankr. LEXIS 3699, 36.

[29] See text accompanying footnote 21 above.

because has provided money to a struggling company, actually intended to realize an equity contribution into such company. However, the insider status of the lender alone would have little meaning, if it is not put in connection with the overall relationship between lender(s) and borrower. For instance, if shareholders advance money to the corporation in proportion to their respective equity interests, this evidence standing alone is almost overwhelming in showing that, with the loan, the parties actually intended to conceal an equity contribution[30]. Conversely, if there is a disproportionate ratio between the lender's equity interest in the corporation and the loan, there is an indication of *bona fide* debt[31]. Also, if the amount of control exercised by the lender on the corporation is increased as a result of the transaction the courts will probably characterize the latter as equity contribution[32]. More generally, any time a lender obtains the right to control the company's operations, the court considers the transaction an equity contribution[33].

The intent of the parties may also be inferred by the analysis of the way they expect the borrower to use the advances and of the way they expect such advances to be repaid. As to the first issue, generally courts deem that the use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of *bona fide* indebtedness[34]. However, it must be noted that in one case the court read the same circumstances in a completely opposite manner, holding that the debtor was in need of working capital and that, therefore, the parties' intent was to provide an equity contribution[35]. As to the issue of the source of repayment, the general rule is that if the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution[36]. The reason for this rule is clear: if the capital provided is treated by the parties as "risk capital", then the "lender" cannot escape the inherent consequences of business ownership by labeling its investment as "loan". Consistently, the court of *In re Phase-I Molecular Toxicology* was persuaded that the transaction was a loan and not an equity contribution, *inter alia*, by the fact that the intended repayment was expected to be received from the sale of assets and, therefore, was not entirely dependent on the future success of the debtor's business [37].

5 Protection of outside creditors

As discussed above, several bankruptcy courts relied on substantive factors in order to determine the actual intent of the parties. However, the role of such factors should not be limited to this. Courts have often relied on these factors also in order to determine the *degree of dangerousness* of a transaction with respect to the outside *bona fide* creditors of the company.

Trying to simplify the issue as much as possible, the equity capital of a company may be regarded as a minimal and basic protection granted to: (i) unsophisticated third parties that decide to deal with a company but cannot or do not want to provide independently for more intensive tools (e.g., trade creditors)[38] or (ii) involuntary creditors of the company (e.g., holders of a credit deriving from a damage claim). Many legal systems, especially those of European civil law Countries, set forth specific rules on the constitution of the corporate capital and its minimum amount, which vary depending on the kind of corporate entity and on the industry in which the latter is involved (*i.e.*, the minimum amount of capitalization increases according to the presumed magnitude of the activities carried out and the inherent amount of risk with respect to third parties). The adoption of rules on minimum capitalization is perhaps more justified in civil law systems, where judges prefer to enforce relatively bright-line rules, rather than developing standards for the protection of corporate creditors, such as fiduciary duties, piercing the veil, fraudulent conveyance, equitable subordination, recharacterization, and other instruments developed in common law jurisdictions[39].

Although the balance points between the privilege of limited liability and a fair use of the corporate entity vary from one to the other legal system, in any case, the ultimate goal may be considered as similar: preventing shareholders from avoiding the responsibilities and risks related to entrepreneurial activities by unfairly manipulating the corporate instruments to their advantage[40].

[30] In re Cold Harbor, 204 B.R. at 919.

[31] AutoStyle Plastics, Inc., 269 F.3d 726, 751.

[32] See Estate of Mixon, 464 F.2d 394, 406 (5th Cir. 1972) (noting that when debtor grants creditor participation in management as result of advances, management participation is evidence of capital contribution by creditor); Cold Harbor, 204 B.R. at 917 (observing that one characteristic of equity contribution is participation in management), both cited in 2004 Annual Survey of Bankruptcy Law, cit., at 711.

[33] M. NOZEMACK, Note, cit., at 711.

[34] AutoStyle Plastics, Inc., 269 F.3d 726, 752 (citing Roth Steel Tube, 800 F.2d 625, 632).

[35] Matter of Transystems, Inc., 569 F.2d 1364, 1370 (5th Cir. 1978).

[36] AutoStyle Plastics, Inc., 269 F.3d 726, 751 (citing Roth Steel Tube, 800 F.2d 625, 631).

[37] In re Phase-I Molecular Toxicology, 287 B.R. 571, 577, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).

[38] M. LUTTER, Das Kapital der Aktiengesellschaft in Europa, 2006, p. 643.

[39] IBID., p. 653.

[40] For a comparative corporate governance perspective see: M. P. DOOLEY, Two Models of Corporate Governance, in Bus. Law., 1992, n.48, p. 470; L. ENRIQUES, Codici di Corporate Governance, diritto societario e assetti

With respect to recharacterization, the undercapitalization of the borrowing company is constantly seen by bankruptcy courts as an index of a suspicious transaction. Doctrinally, undercapitalization may be divided into two categories: "nominal" and "material" undercapitalization. A corporation is "nominally undercapitalized" when, even though it actually has sufficient financial means to pursue its corporate purpose and to face its obligations towards outside creditors, such financial means are mainly provided by the shareholders as debt capital, rather than as "risk capital" (i.e., equity, which is instead provided to an insufficient extent). Conversely, a corporation is "materially undercapitalized" when both equity and debt contributions are insufficient, with the result that the corporation is unable to face its obligations as they become due[41].

It is useful to bear in mind that the event that triggers the possibility to bring a claim for recharacterization is the initiation of a bankruptcy proceeding, meaning that the corporation, at a certain moment in its life, became "materially undercapitalized". However, when bankruptcy courts analyze the capitalization of a corporation in order to understand whether it is adequate or inadequate, they implicitly refer to the concept of "nominal undercapitalization", which is generally seen as a strong evidence of an equity contribution. For example, the court of *In re Cold Harbor* stated that the issue of undercapitalization is particularly important when the corporation is started by the shareholders with a minimal amount of capital who then make a large loan of money to the newly formed corporation[42]. Also, in *Pepper v. Litton* the U.S. Supreme Court stated that so-called loans or advances by a dominant or controlling shareholder will be subordinated to claims of other creditors, and thus treated as capital contributions, where *the paid-in capital is purely nominal*, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholders as a loan[43]. In such cases, the Supreme Court goes on, shareholders should not be allowed to manipulate the corporate device in order to avail themselves of privileges normally permitted to outside creditors. From these decisions it can be inferred that, for a transaction to be characterized as equity, it is not necessary that the borrower was materially undercapitalized, being it is also sufficient that there was an ongoing situation of nominal undercapitalization before the relevant transaction was carried out.

The definition of inadequate capitalization adopted by some U.S. bankruptcy courts somehow recalls the same policy reasons underlying the rules on minimum corporate capital of civil law systems: the higher is the risk for third parties in connection with the activities carried out by the corporation, the higher must be the capitalization. For instance, the court of *Diasonics, Inc. v. Ingall* stated that capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized[44].

The efforts to protect outside creditors have been brought to extreme consequences by some courts, which held that shareholder loans may be deemed capital contribution in one of two circumstances: (i) where the plaintiff proves initial undercapitalization; or (ii) where the plaintiff proves that the loans were made when no other disinterested lender would have extended credit[45]. In particular, the court of *Diasonics* held that this is the appropriate standard of review to be applied in the 11th Circuit[46]. Interestingly, these two circumstances are not cumulative, therefore in order to recharacterize a claim in the 11th Circuit, it is sufficient that only one of them is proven by the plaintiff[47].

proprietari: alcuni aspetti preliminari, in Banca Impr. Soc., 2003, n.1, p. 97; K. J. HOPT, H. KANDA, M. J. ROE, E. WYMEERSCH, S. PRIGGE (edited by), Comparative Corporate Governance - The State of Art and Emerging Research - , Oxford,1998; U. MATTEI, F. SARTORI, Conflitto continuo. A un anno da Enron negli Stati Uniti e in Europa in Politica del diritto, anno XXXIV, 2003 p. 177; G. VISENTINI, Compatibility and Competition between European and American Corporate Governance: Which Model of Capitalism?, in Brook. J. Int'l L., 1998, n.3, p. 833; B. CHEFFINS, The History of Corporate Governance, ECGI Law Working Paper No. 184/2012, January 2012; K. HOPT, Corporate Governance of Banks after the Financial Crisis, ECGI Law Working Paper No. 181/2011, September 2011; K. HOPT, Comparative Corporate Governance: The State of the Art and International Regulation ECGI Law Working Paper No. 170/2011, November 2010.

[41] G.B. PORTALE, Rivista delle società, n. 1/1991, Capitale sociale e società per azioni sottocapitalizzata, 29.

[42] In re Cold Harbor, 204 B.R. at 917.

[43] Pepper v. Litton, cit. at 309-310.

[44] Diasonics, Inc. v. Ingall, 121 B.R. 626, at 631 (citing In re Multiponics, 622 F.2d 709, 717 (5th Cir. 1980).

[45] In re N&D Properties, Inc., 799 F.2d 726 (11th Cir. 1986).

[46] Diasonics, Inc. v. Ingall, 121 B.R. 626, at 631.

[47] See also In re N & D Properties, Inc., 799 F.2d 726, 733, 15 Bankr. Ct. Dec. (CRR) 254, 15 Collier Bankr. Cas. 2d (MB) 726 (11th Cir. 1986) (''Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.''); Matter of Herby's Foods, Inc., 2 F.3d 128, 132, 24 Bankr. Ct. Dec. (CRR) 1116, 29 Collier Bankr. Cas. 2d (MB) 1375, Bankr. L. Rep. (CCH) ¶ 75446 (5th Cir. 1993) (''[I]f an insider makes a loan to an undercapitalized corporation, the combination of undercapitalization and the insider loan may

Furthermore, from a literal reading of the opinion, it seems sufficient that a corporation was *initially* undercapitalized in order to characterize as capital contribution any shareholder loan extended to such corporation. The following hypothetical can probably show the limits of this approach: a corporation is started with insufficient capital but, during the course of its life, is adequately capitalized with equity contributions by stockholders. After several years during which the corporation entered in dealing with third parties and regularly met its obligations, the corporation begins to suffer overwhelming losses due to deteriorated market conditions. In such a situation, an insider would probably be the only entity willing to extend credit to the corporation. In this case, the application of a strict *Diasonics* test would certainly lead to the recharacterization of any shareholder loan extended to the corporation. In particular, a *per se* application of the second factor mentioned above would prevent any shareholder or insider from ever loaning money to a company experiencing distress[48].

It is true that shareholders should not be left entirely free to manipulate the corporate devices as to avoid the consequences of business ownership; however, the test developed by the 11th Circuits seems to lead to undesirable results. What is then the standard of review that should be adopted by bankruptcy courts?

Furthermore, analyzing the recharacterization issue from a corporate governance point of view – considering the combination and the bi-lateral effects of inside and outside corporate governance elements and controls – it may be possible to determine whether a potential effect of recharacterization on a company's "inside" corporate governance (shareholders-directors relationships and controls) could generate a benefit also for outside creditors and other stakeholders.

Paragraph 7 tries to answer these questions in the light of some policy considerations.

6 Policy reasons underlying recharacterization

It is now time to formulate the basic policy questions underlying the issue of recharacterization. These questions are: should shareholder loans to distressed companies be permitted or prohibited? Do transactions of this kind impair the rights of outside *bona fide* creditors[49]? Does the recharacterization influence the corporate governance of the company?

The basic answer that should be given to these questions is that shareholder loans to a company facing liquidity crisis should not be *per se* prohibited. As discussed above, if a shareholder loan is the only way to keep the corporation alive and avoid bankruptcy, it seems excessive to think that shareholders should not be permitted to extend such a loan to the corporation.

An argument that could be used to justify the permissibility of shareholder loans in the abovementioned situation is that, if the corporation is facing *material* undercapitalization, a cash contribution by an insider can be beneficial also to pre-existing outside unsecured creditors. In fact, cash streams going into the company, would normally be used to meet the debtor's obligations toward outside creditors as they become due and, therefore, would be somehow "distributed" to them. In this context, the rule developed by *AutoStyle Plastic* – that the use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of *bona fide* indebtedness[50] – assumes a new significance: besides the aim of determining the parties' intent, such factor may also be used in order to evaluate whether the transaction is beneficial or detrimental to pre-existing outside creditors. In any case, without such transaction, the company would remain "materially undercapitalized" and, therefore, outside unsecured creditors would normally not be able to recover the whole amount of their respective credits from a bankruptcy proceeding.

This argument seems acceptable if analyzed in the perspective of pre-existing creditors. However, one could wonder: what happens after the shareholder loan is extended to the company? Starting from that moment, the corporation will not be *materially* undercapitalized anymore, but would then become *nominally* undercapitalized. Such corporation will then continue to deal with pre-existing creditors accumulating new indebtedness (e.g., trade creditors will probably continue to provide goods or services to the corporation) and probably will also enter into some kind of relationship with new voluntary creditors (e.g., new suppliers) or even with involuntary creditors (e.g., someone who is damaged by the corporation). In this case, the post-transaction creditors will be dealing with a *nominally* undercapitalized company and, in case of insolvency of the latter, they will concur *pari passu* with the insider-lender for the satisfaction of their credit.

allow the bankruptcy court to recharacterize the loan as a capital contribution''); Matter of Fabricators, Inc., 926 F.2d 1458, 1469, 21 Bankr. Ct. Dec. (CRR) 809, 24 Collier Bankr. Cas. 2d (MB) 1489, Bankr. L. Rep. (CCH) ¶ 73875 (5th Cir. 1991) (''When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital").

[48] 2004 Annual Survey of Bankruptcy Law, cit., footnote 88 and accompanying text.

[49] Furthermore, assuming that in certain circumstances shareholders are the only subjects willing to provide cash to a struggling corporation, how should the legitimate purpose of keeping the corporation alive be balanced with the rights of outside bona fide creditors?

[50] AutoStyle Plastics, Inc., 269 F.3d 726, 752 (citing Roth Steel Tube, 800 F.2d 625, 632).

Actually, given that insider-lenders will usually secure their credit with a lien over (some of) the assets of the corporation, the post-transaction outside creditors will also be deprived of the value of such assets as a source for the repayment of their credit. In the context of recharacterization, this risks are not merely theoretical: it must be borne in mind that, if a recharacterization claim has been brought before a court, it means that the debtor eventually became insolvent and that there is an actual ongoing bankruptcy proceeding. In these circumstances, it is hard to argument that the shareholder loan was beneficial to post-transaction outside unsecured creditors, especially those who became creditors of the corporation in a period of time close to the beginning of the bankruptcy proceeding.

It is difficult to find the right balance between the legitimate reasons of creditors and the equally legitimate interest of stakeholders of keeping the corporation alive and protecting their initial equity interest. The *Diasonics* test is probably overreaching, given that its second prong actually prohibits any insider loan to undercapitalized entities. On the other hand, it seems reasonable to hold that if a company was undercapitalized *both* at the beginning of its life and at the time of the transaction, shareholders should not be allowed to have their claim repaid before, or *pari passu* with, outside creditors. It is worth mentioning that, consistently with the above considerations, the majority of courts does not believe that undercapitalization must be present only at the beginning of the life of the corporation. For example, the *AutoStyle Plastic* court pointed out that capitalization is not to be assessed only at the moment of initial capitalization, but also at the time when the advance was made.

Enduring undercapitalization is therefore one of the most important elements to be considered by courts, with the specification that this element should not be considered *per se* sufficient to characterize a purported debt claim as equity. In fact, the Fourth Circuit noted that a claimant's insider status and a debtor's undercapitalization alone will normally be insufficient to support the recharacterization of a claim, pointing out that "in many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans."[51] An interesting approach, with respect to undercapitalization, has been taken in *AtlanticRancher*, where the court tried to put in relation the financial failure of the debtor with its "chronic undercapitalization". One of the factors analyzed by the court was, in fact, whether or not undercapitalization was the most important cause of the debtor's financial failure[52]. Therefore, one could argue that, if the company is deliberately kept by shareholders in a chronic condition of undercapitalization (even only nominal), when such shareholders decide – in order to remedy to a contingent situation of material undercapitalization – to extend a loan to the company, they should not be allowed to the protections of genuine creditorship if the corporation then actually goes bankrupt.

An additional element that could be – and in fact has been – evaluated by some courts is whether the loan had the character of an arm's length transaction and, in particular, whether bankruptcy was actually evitable when the loan has been extended to the debtor. In particular, the court of *Trimble* held that at the time of the loan no financial institution would have been willing to extend credit, because the business was a "hopelessly insolvent corporate structure"[53]. If it is true that one of the policy reasons why insider loans should not be discouraged is that they may be the only means to keep a distressed corporation alive, then it is also true that, if from an *ex-ante* evaluation of the overall circumstances – the corporation seems to be "hopelessly insolvent", the insider should not be encouraged to extend a useless loan to such a corporation. One of the elements that could be considered in order to determine whether the insider-lender was aware (or ought to be aware) of the inevitability of bankruptcy could be the closeness of the transaction to the actual beginning of the bankruptcy proceeding. Even if it would be risky to give too much relevance to such a temporal factor, it seems certainly reasonable to think that a shareholder loan extended on the verge of bankruptcy should be subject to careful judicial scrutiny.

The above mentioned conclusions have also an impact on the corporate governance of corporations. Notably, corporate governance systems around the world are converging towards the long-term growth of the companies because corporate managers' obsession with short-term shareholder wealth maximization has, in many instances, diverted their attention from the efficient operation of their companies. In order to make the company profitable in the long run, corporations need to invest capital in the long-term endeavours, which often have a significant time lag between the time of investment and the eventual returns[54].

Therefore, assuming that companies should be managed with a long-term view, whenever equity prevails over debt, corporate managers could pursue the creation and preservation of the sustainable

[51] 28-2 ABIJ 42, 42-43, citing In re Official Committee of Unsecured Creditors for Dormer Aviation (N. Am.) Inc., 453 F.3d 225, 234 (4th Cir. 2006).

[52] In re AtlanticRancher, Inc., 279 B.R. 411, 436 (Bankr. D. Mass. 2002).

[53] In re Trimble Co., 479 F.2d 103, 118 (3d Cir. 1973).

[54] See A. SACCO GINEVRI, The Rise of Long-Term Minority Shareholders' Righs in Publicly Held Corporations and Its Effect on Corporate Governance, in European Business Organization Law Review (EBOR), 2011, p. 587.

economic long-term growth of their company because the interest represented by the stock is generally of unlimited duration[55] – so allowing directors to invest in long-term strategies – while short loan duration is generally preferred by lenders to limit the danger to debtholders of wealth transfers to equityholders resulting from investment and dividend decisions[56].

In a nutshell, legal devices like the practice of recharacterization of debt to equity better stimulate better corporate governance by helping management and directors to act with a long-term focus. And, moving the lens back to the global corporate governance overview, this also means that a "two-tier benefit" could reach the outside creditors of the corporation: on one hand, a device such as recharacterization directly protects the corporation's capitalization, on the other hand, long-term corporate strategies, focusing on the corporation's stability and development process[57], provide an indirect protection for outside creditors and for the qualified interests of the stakeholders in general[58].

7 Conclusions

There is no magical formula that can be provided in the context of recharacterization; every solution one can elaborate will certainly have its merits and flaws. Some standards of review may be too rigid and overreaching (such as the *Diasonics* factors) and some others are probably too loose (such as those standards that give too much relevance to the formal factors).

An acceptable mean solution can perhaps be found in those standards of review that refuse a mechanical application of the multi-factor tests and privilege a comprehensive approach that can lead to a *common sense* evaluation of the facts and circumstances surrounding a transaction[59].

As already discussed, some of the factors developed by courts – in particular those referred to above as "substantial factors" – shall certainly be helpful in reaching such a common sense understanding of the transaction; mainly because these elements may be used to infer the *objective intent* of the parties. In this context, it seems helpful to take into account, without limitations: (i) the ratio between shareholder loan and equity interest; (ii) the amount of control exercised by the lender pre and post transaction; and (iii) the source of repayments.

Courts should also take into account the policy principles underlying recharacterization and, therefore, consider whether: (aa) streams of cash deriving from the transaction are used by the borrower to finance its day-by-day operation (including, *inter alia*, payment of payrolls or trade debts as they become due), rather than to purchase capital assets; (bb) undercapitalization seems to derive from temporary contingencies or seems to be *chronic* and *deliberate*; and (cc) the insider-lender, at the time of the facts, could reasonably believe that the transaction could actually be used to avoid bankruptcy.

In any case, when an insider cannot be relatively sure that its loan would not be recharacterized as debt, the only solution that may grant an acceptable degree of certainty would be to extend a loan with court approval after the business files a petition for reorganization (or a combination of a capital infusion with a debt restructuring, commonly referred to as Shared Pain Restructuring)[60]. By proceeding in this manner, insiders not only avoid the risk of recharacterization, but also may obtain a first priority as an administrative expense[61]. This solution would certainly lead to an increase in the number of filings for bankruptcy, but would also ensure – through the authority of bankruptcy courts – a reasonable balance between the need to preserve the value of the going concern and the protection of the rights of pre-existing and post-restructuring outside creditors.

Last but not least, judicial tools that legitimate and expand the recharacterization of debt to equity indirectly influence the long-term growth of the company because – extending the duration of its financial resources – allow directors to manage their enterprises in a manner that emphasizes the long-term over the short-term.

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[55] In other words, there is usually no initially agreed-upon point in time when a common shareholder becomes entitled to demand the return of his or her initial contribution or some other amount.

[56] William A.KLEIN, John C.COFFEE Jr., Frank PARTONOY, Business Organization and Finance, Foundation Press, New York, 2010, 282.

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[58] Considering the stakeholder definition as "any group or individual that can affect or be affected by a company's purpose", or "the community from which the business draws its resources", given by R. EDWARD FREEMAN, Strategic management: a stakeholder approach, Cambridge University Press, 2010. See also R. EDWARD FREEMAN, W. EVAN, A stakeholder theory of modern corporation: the Kantian capitalism, in Ethical Theory and Business, 1988.

[59] Radnor, 353 B.R. 820, 838; 2006 Bankr. LEXIS 3699, 36.

[60] 2004 Annual Survey of Bankruptcy Law, cit., p. 28.

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